

**EVENTS AND ACTIONS UNDERTAKEN IN RELATION  
TO CORPORATE COMMERCIAL BANK AD  
AND COMMERCIAL BANK VICTORIA EAD**

A Report, Prepared by the Bulgarian National Bank  
for Information of the Members of the 43rd National  
Assembly of the Republic of Bulgaria

**EVENTS AND ACTIONS UNDERTAKEN IN RELATION  
TO CORPORATE COMMERCIAL BANK AD  
AND COMMERCIAL BANK VICTORIA EAD**

A Report, Prepared by the Bulgarian National Bank  
for Information of the Members of the 43rd National  
Assembly of the Republic of Bulgaria

Sofia, 27 October 2014



## **LADIES AND GENTLEMEN MEMBERS OF PARLIAMENT:**

The case with Corporate Commercial Bank AD (KTB) and Commercial Bank Victoria EAD (CB Victoria) placed under special supervision continues to attract reasonably great public interest and to provoke robust debate on national financial and macroeconomic stability. The issue is also in the centre of the political debate, with all parliamentary political forces entirely understandably sharing an appreciation of its key significance and of the need to find a rapid and adequate solution to the KTB issue as a matter of priority.

From the outset, the topic was the subject of great media, political, and public interest that filled the public arena with the most varied of opinions and ideas accompanied by diverse comment and public statements. Alongside useful expert opinion by specialists in this strictly professional area, we heard a multitude of construals entirely devoid of argumentation or objectivity. This greatly occluded a proper understanding of the actions undertaken by the various institutions involved, while even well intentioned comment occasionally hampered the emergence of a strategic consensus on ways to resolve the issue. There were also a number of attempts to cast the work of the BNB in the wrong light.

There were a number of accusations and instances of public criticism of the institutions responsible for resolving this complicated issue, and even attempts to exercise public pressure on the central bank which is an independent institution under both Bulgarian and European law.

It is against this background, and to help Members of Parliament arrive at an informed decision on KTB, that the BNB Governing Council presents to your attention detailed information on the events and all actions undertaken and decisions made by the BNB on the KTB group from 20 June 2014 (the date of placing KTB under special supervision) to date.

Part of the enclosed information is being presented to you and the public at large for the first time and it presents in an orderly manner details about the initial financial position of KTB and CB Victoria, conclusions from the new supervisory inspection in KTB, communication with its main shareholders, and the correspondence between the BNB and the European Commission, the European Banking Authority and the International Monetary Fund. The follow-up steps to be undertaken under the existing legislation are outlined.

The provision of this exhaustive information fully complies with the principle of openness and transparency of the BNB's activities. We also trust that the attached report will shed more light on the BNB's actions which, from the very beginning, by their logic and order, strictly obey the existing legal framework and procedures.

We trust the BNB would thus assist the Members of Parliament in taking timely and adequate decisions considering the short time frames related to the term of the special supervision on the two banks which expires, respectively, on 20 November 2014 for KTB and on 22 November 2014 for CB Victoria.

May we also use this opportunity to call on you, given the exceptionally short time available for formulating a decision, to set up an *ad hoc* Committee with the participation of all parliamentary political forces, which should discuss with high priority the KTB case along with the start of your work and in parallel with the setting up and the commencement of the full-fledged work of the 43rd National Assembly.

As always, the BNB, with its expertise, remains at the disposal of the Members of Parliament and we are ready at any time to respond to further questions and to provide additional information within our competences, including for drafting new legislative proposals, if the 43rd National Assembly considers that these are needed.

## **GOVERNING COUNCIL OF THE BULGARIAN NATIONAL BANK**

# CONTENTS

<b>I.</b>	<b>THE INITIAL CONDITIONS</b> .....	7
1.	FINANCIAL INFORMATION ABOUT CORPORATE COMMERCIAL BANK AD AS OF 31 MARCH 2014 AND RESULTS OF THE LATEST SUPERVISORY INSPECTION CONDUCTED IN THE BANK BETWEEN 20 MAY AND 8 JULY 2013.....	7
2.	FINANCIAL INFORMATION ABOUT COMMERCIAL BANK VICTORIA EAD (FORMER CRÉDIT AGRICOLE, BULGARIA EAD) AS OF 31 MARCH 2014 BASED ON FINANCIAL REPORTING PROVIDED BY THE BANK AND THE RESULTS OF THE LATEST SUPERVISORY INSPECTION CONDUCTED AS OF 31 MARCH 2013 .....	10
<b>II.</b>	<b>EVENTS RELATING TO CORPORATE COMMERCIAL BANK AD AND COMMERCIAL BANK VICTORIA EAD, AND THE BNB MEASURES</b> .....	13
<b>III.</b>	<b>PURPOSE, SCOPE AND CONCLUSIONS OF THE SUPERVISORY INSPECTION IN CORPORATE COMMERCIAL BANK CONDUCTED IN THE PERIOD 7.07. – 14.10.2014, BASED ON DATA AS OF 30.06.2014</b> .....	32
<b>IV.</b>	<b>BNB’S WORK WITH THE MAJOR SHAREHOLDERS OF CORPORATE COMMERCIAL BANK AD</b> .....	38
<b>V.</b>	<b>BNB’S ACTIONS CONCERNING CONDUCTING A REVIEW OF THE SUPERVISORY FRAMEWORK AND PRACTICES</b> .....	44
1.	WORK WITH THE EUROPEAN BANKING AUTHORITY .....	44
2.	WORK WITH THE INTERNATIONAL MONETARY FUND (IMF).....	44
<b>VI.</b>	<b>BNB’S ACTIONS TOWARDS PROVIDING ACCESS TO DEPOSITS WITH CORPORATE COMMERCIAL BANK AD</b> ..	46
1.	WORK WITH THE EUROPEAN COMMISSION.....	46
2.	WORK WITH THE EUROPEAN BANKING AUTHORITY .....	52



# **I. THE INITIAL CONDITIONS**

## **1. FINANCIAL INFORMATION ABOUT CORPORATE COMMERCIAL BANK AD AS OF 31 MARCH 2014 AND RESULTS OF THE LATEST SUPERVISORY INSPECTION CONDUCTED IN THE BANK BETWEEN 20 MAY AND 8 JULY 2013**

As of 31 March 2014 Corporate Commercial Bank AD (KTB) reported assets amounting to BGN 7302 million<sup>1</sup>. Compared with 31 December 2013 the total amount of assets increased by BGN 562 million or 8.34 per cent, mainly as a result of the increase in securities (by BGN 319 million) and of the corporate credit portfolio (by BGN 346 million). Other essential balance sheet changes relate to growth of BGN 503 million of attracted funds from individuals and households and to the reported subordinated term debt amounting to the lev equivalent of EUR 35 million. Over the review period the bank sold entirely its equity holding in the capital of Velder Consult OOD, which explains the drop in subsidiary investments by BGN 2.4 million.

No significant changes prompting a change to the bank's risk profile were reported in the first quarter. High levels of credit risk and concentration risk continued to be dominant for the institution. Based on data reported by the bank large loans extended under Ordinance No. 7 of the BNB (repealed in April 2014) numbered 20 at a total gross amount of BGN 1488.9 million, accounting for 29 per cent of the bank's credit portfolio or 193 per cent of its own funds (BGN 758.6 million). This includes nine exposures at a total balance sheet value of BGN 870 million to groups of connected persons in terms of 'ownership', or 'control', or 'management' (in accordance with the requirements of § 1, item 4 of the Additional Provisions of the Law on Credit Institutions), and 11 exposures to individual customers.

In compliance with Regulation No 575/2013 (effective as of 1 January 2014) the bank reported 20 large exposures totalling BGN 1608.6 million after the application of exemptions and mitigations of credit risk, or 210 per cent of the own funds (amounting to BGN 765 million). This includes, nine exposures at a total balance sheet value of BGN 828 million to groups of connected persons in terms of 'control', or as 'persons presenting joint risk' (distributed in 21 separate exposures), and 11 exposures to individual customers.

Based on the data reported by the bank as of 31 March 2014 the gross amount of standard exposures came to BGN 5082.4 million, accounting for 98.7 per cent

---

<sup>1</sup> Detailed quarterly individual data about banks, including KTB, and foreign bank branches in Bulgaria are published on the BNB website.

of total gross loans, with their volume growing by BGN 361.1 million over the review period. Bank's gross classified exposures retained their downward trend posting a decline by BGN 19 million to BGN 63 million in the period under review. Exposures classified as loss exhibited the strongest decrease and reached BGN 40 million. Movements were observed also in other classification groups: non-performing exposures reported an insignificant increase from BGN 0.8 million to BGN 8.3 million, watch exposures posted a decrease by BGN 8 million to reach BGN 14.7 million. The impairment of classified exposures under the applicable accounting standards (IAS 39) was 4.6 per cent which was significantly under the average banking system values (35 per cent).

Renegotiated exposures amounted to BGN 374 million and accounted for 7 per cent of total loans and advances. In accordance with bank's reports the quality of renegotiated exposures is acceptable, with classified exposures comprising only 6 per cent of renegotiated exposures. No restructured exposures were reported by the bank.

Over the quarter three exposures totalling BGN 5 million were written off. Fifty-two exposures amounting to BGN 9 million were entirely impaired but not written off.

Based on bank's data reported by 31 March 2014 the net non-performing loans came to BGN 19,748,000, accounting for 0.4 per cent of the net credit portfolio against 0.6 per cent by 31 December 2013, or BGN 29 million.

Over the review period the bank's capital positions rose to BGN 758.6 million as a result of the inclusion of the annual audited profit and subordinated term debt amounting to the lev equivalent of EUR 35 million. The reported higher own funds were a base allowing for stronger growth of loans over the review period and, correspondingly, of the risk component.

Based on data reported by the bank under BNB Ordinance No 8 on the Capital Adequacy, over the review period the capital requirements for covering risks rose by BGN 47 million to BGN 664 million. Of this, capital requirements for credit risk amounted to BGN 424 million or 64 per cent of total capital requirements, and additional requirements accounted for 33 per cent or BGN 221 million compared with total capital requirements. To cover market risk the bank allocated BGN 1.4 million, accounting for 0.2 per cent of total requirements, funds for covering operational risk amounted to BGN 17 million, comprising 2.6 per cent of total capital requirements.

Based on data reported by the bank under BNB Ordinance No. 8 on the Capital Adequacy major capital adequacy ratios rose insignificantly by 1.15 per cent to 13.71 per cent. Concurrently, in accordance with Regulation 575/EU the bank's equity amounted to BGN 764.7 million, overall capital adequacy 13.85 per cent, and Tier 1 capital ratio 10.64 per cent. Capital ratios reported by the bank exceeded the minimum required ratios (both under Ordinance No. 8 and the Regulation).

The difference in favour of the capital ratios computed in accordance with the new arrangements was due to the changes made to the requirements in respect of quantitative and qualitative characteristics of elements used for computing capital adequacy.

Based on data provided by the bank the financial result for the first quarter reported a profit in the amount of BGN 13.1 million formed by core banking operations. The lower impairment accrued under IAS 39 on the credit portfolio and the dividend received in the amount of BGN 1.8 million had a positive effect on the financial result. The return on assets (ROA=0.7 per cent) is commensurate with that reported in the corresponding period of the previous year, while the return on equity (ROE=8.9 per cent) is lower reflecting the increase in the capital. Net interest margin narrowed over the review period to 1.4 per cent and was lower than average values for the banking system. The bank maintains a high cost of interest liabilities due to their structure which is dominated by funds attracted from individuals.

Based on data reported by the bank liquid assets grew over the reporting period. Cash and cash balances with the BNB accounted for the largest share in the structure of assets: 71 per cent. Marketable assets ranked second. Liquidity ratios (liquid assets/net assets=17.4 per cent and liquid assets/attracted funds=19.6 per cent) posted a decline of a half per cent over the review period. The gross loans to deposits ratio accounted for 81 per cent and almost matched average values for the banking system. Funds attracted from individuals continued to increase accounting for 67 per cent of total attracted funds. Funds attracted from companies comprised 28 per cent and ranked second. Liquid assets were maintained at the recommended 20 per cent minimum coverage level of funds attracted from companies and individuals.

The latest supervisory inspection in KTB prior to its placement under special supervision on 20 June 2014 was carried out in the period 20 May – 8 July 2013 based on data as of 31 March 2013. The scope of the inspection is as follows: analysis and assessment of bank's credit, liquidity and market risk management systems, analysis and assessment of bank's capital position and the internal capital adequacy analysis carried out by the bank; assessment of the institution's corporate management.

No breaches of the regulatory framework were found but the bank was recommended to improve the activities as follows:

- To improve lending activity; insofar as the bank has not reported correctly all renegotiated credit transactions, it should carry out a review of the credit portfolio and report all renegotiated credit transactions; strengthen control over timely data revision in declarations of economically connected persons; supplement the concentration analyses with information on the amount and maturity of loans.
- To take into account the effect of stress tests results on the bank's capital, to include in the reports on the risk level information on decisions made by the bank's management based on the stress tests results.

- The function on compliance with internal rules of procedures and banking regulatory framework should be combined into a single unit after a management decision has been made on the subordination of the unit.
- To improve the process of internal capital adequacy analysis aimed at finding a more effective approach in computing the required internal capital for covering the inherent risks corresponding to bank's operations and the business model.

## **2. FINANCIAL INFORMATION ABOUT COMMERCIAL BANK VICTORIA EAD (FORMER CRÉDIT AGRICOLE, BULGARIA EAD) AS OF 31 MARCH 2014 BASED ON FINANCIAL REPORTING PROVIDED BY THE BANK AND THE RESULTS OF THE LATEST SUPERVISORY INSPECTION CONDUCTED AS OF 31 MARCH 2013**

Between 31 December 2013 and 31 March 2014 total assets of Crédit Agricole went down by BGN 4.191 million or 1 per cent, mainly as a result of the reduction in the corporate credit portfolio (by BGN 15.2 million). Other more essential balance sheet changes relate to decreases in the volume of funds attracted from individuals and households (by BGN 7.3 million) and funds attracted from credit institutions (contracted by BGN 2.1 million) at the expense of increased corporate deposits (by 4 per cent, or BGN 6.6 million). Concurrently, the capital position decreased over the review period due to the accumulated loss amounting to BGN 1.57 million. (By the end of 2013 issued capital was increased by 10 per cent, worth BGN 8 million, deposited by the bank's owner – Crédit Agricole, France.)

No significant changes prompting a change to the bank's risk profile were observed in the first quarter. The contraction of the credit portfolio led to a certain credit risk mitigation, while concentration risk impacted adversely the quality of the credit portfolio. Large loans extended under Ordinance No. 7 of the BNB (repealed in April 2014) numbered 9 at a total gross amount of BGN 47.9 million, accounting for 15 per cent of bank's credit portfolio or 82 per cent of its own funds (BGN 58.3 million). This includes an exposure to Crédit Agricole, France (BGN 8.4 million), three exposures to groups of connected persons in terms of 'ownership', or 'control', or 'management' (in accordance with the requirements of § 1, item 4 of the Additional Provisions of the Law on Credit Institutions) at a total balance sheet value of BGN 6.3 million. The remaining five large exposures were to individual customers.

In compliance with Regulation No. 575/2013 (effective as of 1 January 2014) the bank reported nine large exposures totalling BGN 49.2 million after the application of exemptions and mitigations of credit risk, or 84.5 per cent of the own funds (amounting to BGN 58.3 million). Of this, three exposures are reported to groups of

connected persons as ‘persons presenting joint risk’ (distributed in seven separate exposures) at a total balance sheet value of BGN 23 million, and five exposures are reported to individual customers.

Based on data reported by the bank standard exposures came to BGN 223.6 million, accounting for 71 per cent of total gross loans. Over the review period the amount of these exposures exhibited a decrease by BGN 12.1 million. Bank’s gross classified exposures retained their downward trend posting a decline by BGN 2.8 million to BGN 91.6 million in the period under review. Exposures classified as watch exposures exhibited the strongest decrease and reached BGN 6.96 million. Movements were also observed in other classification groups: non-performing exposures reported growth from BGN 3.26 million to BGN 20.5 million, while exposures classified as loss posted a decrease of BGN 1.7 million to BGN 64.1 million. The impairment of classified exposures under the applicable accounting standards (IAS 39) was 48 per cent which was higher than the average banking system values (35 per cent).

Restructured loans (BGN 34.8 million) accounted for 11 per cent of the gross credit portfolio, with renegotiated loans (BGN 84.2 million) comprising 26.70 per cent of it. By the end of the period the share of net non-performing loans in the net credit portfolio accounted for 15.37 per cent (increasing by 1.44 percentage points on 31 December 2013).

During the quarter five exposures totalling BGN 876,000 were written off. Two exposures amounting to BGN 719,000 were entirely impaired but not written off.

As of 31 March 2014 net non-performing loans came to BGN 41.6 million, accounting for 15.37 per cent of the net credit portfolio against 13.92 per cent by 31 December 2013, or BGN 39.7 million.

Over the review period the bank’s capital position reported growth by BGN 14.2 million to BGN 58.3 million due to the removed requirement for reporting specific provisions for credit risk as a decrease in the bank’s own funds. The allocated total capital buffer over the regulatory required minimum increased substantially. As of 31 December 2013 capital reserves formed by specific provisions for credit risk amounted to BGN 15.6 million. The implementation of the new capital framework affected mainly the volume of capital requirements for credit risk, posing an increase by BGN 321,000. By the end of the review period the latter accounted for 88.95 per cent of total capital requirements exhibiting a nominal decrease by BGN 292,000 due to operational risk requirements (market risks were not reported by the bank). In accordance with Regulation 575/2013/EU the bank’s overall capital adequacy is 21.31 per cent, and the Tier 1 capital adequacy is 15 per cent.

The financial result for the first quarter reported a loss in the amount of BGN 1.571 million. Despite the lower net negative result, over a 12-month period, the adverse trends in the quality of assets, the net interest income and the average gross interest-bearing assets limited the bank’s ability to generate profit. The return

on assets (ROA) is -1.54 per cent showing an improvement compared with the end of the previous year (-3.1 per cent).

Liquid assets increased over the reporting period. Cash and cash balances with the BNB accounted for the largest share in the structure of assets: 85.5 per cent. Liquidity ratios (liquid assets to net assets accounting for 20.29 per cent and liquid assets to attracted funds 24.37 per cent) posted growth over the review period. The gross loans to deposits ratio accounted for 128 per cent and declined compared with previous reporting periods.

The latest full supervisory inspection was carried out for the reporting period ending 31 March 2013.

No breaches of the regulatory framework were found but the bank was recommended to improve the activities as follows:

- Timely updating of internal regulatory documents and sending them to the BNB within the legally set term.
- Improvement of collateral liquidation on adjudicated claims.
- Preparing the bank's budget to take into account the bank's real capacity.
- Given the strong pressure on the capital and the lack of internal sources for a capital increase, additional capital support by the major shareholder is required.
- The bank should set minimum capital indicator levels corresponding to the institution's risk profile. Upon reaching these levels, measures aimed at increasing the capital should be initiated.

## II. EVENTS RELATING TO CORPORATE COMMERCIAL BANK AD AND COMMERCIAL BANK VICTORIA EAD, AND THE BNB MEASURES

In the **weeks prior to 17 June 2014** a number of publications in the media, Internet and social networks focused on the state of KTB.

**After 12 June 2014** a strong run on KTB, both in cash and by bank transfers, was observed. Between 13 and 20 June the outflow of attracted funds from KTB totalled BGN 907,064,000, accounting for 12.98 per cent of the bank's attracted funds on 13 June 2014.

The comments and events related to KTB affected the behaviour of the customers of CB Victoria owned by KTB<sup>2</sup>. Between 13 and 20 June 2014 the outflow of attracted funds from CB Victoria amounted to BGN 56,241,000, accounting for 17.8 per cent of bank's attracted funds on 13 June 2014.

Growing media speculations and inappropriate comments by representatives of political forces prompted the BNB to note the following in a **17 June 2014** press release:

- The bank closely and carefully monitors the developments across the banking sector, including KTB, and on this basis reiterates that the banking system, including KTB, has high liquidity and capital adequacy and operates normally;
- The central bank is led solely by the public interest and has always been above transient political or business enmities;
- The bank calls on all public, political, and media figures to make responsible public statements and refrain from rash insinuations.

There followed a brief fall in the run on KTB.

On the morning of **18 June 2014** a number of media simultaneously received an email signed by a person presenting himself/herself as a BNB officer (the BNB later stated it employed no officer with that name). The anonymous letter was circulated

---

<sup>2</sup> The share of this bank (former name Crédit Agricole, Bulgaria EAD) accounted for a mere 0.45 per cent of banking system assets by June 2014. After the acquisition of 100 per cent of the bank's equity by KTB in June 2014 the general meeting of shareholders of Crédit Agricole Bulgaria EAD decided to change the name of the bank. The change of the name had not been completed by the time of placing the bank under special supervision. In order to avoid negative communication effects for Crédit Agricole S.A., a respected international financial institution, which traditionally maintains excellent supervisory relations with the BNB, the Governing Council of the BNB instructed the conservators to take the necessary actions for recording the respective changes in the Commercial Register of the Registry Agency. The changes were recorded on 8 August 2014.

on-line and was even read out in full on air by the Bulgarian National Radio (which failed to seek BNB confirmation or opinion in advance). The letter claimed that the BNB Deputy Governor heading the Banking Supervision Department had been summoned to give evidence by the Sofia City Prosecutor's Office. The letter also claimed that he had concealed improprieties at KTB and had failed to exercise due supervision over that bank.

The circulation of the anonymous letter accelerated the run on KTB.

Later that day, the BNB stated in a press release that:

- preliminary proceedings were launched against the BNB Deputy Governor heading the Banking Supervision Department and that, to avoid any suggestion of obstructing the inspection, he had taken leave until the conclusion of the proceedings;
- the responsibilities of a head of the Banking Supervision Department are now performed by the director general of the Department;
- by the time when the BNB was notified that the permit of the BNB Deputy Governor heading the Banking Supervision Department for access to classified information was revoked, his access to documents containing classified information was discontinued.

As a consequence of these events the massive runs on KTB continued.

On the same day, 18 June 2014, a meeting with KTB management was held at the BNB. During the meeting:

- it was found out that available KTB liquid assets were insufficient to meet BNB collateral requirements in order for a loan to be provided from the central bank under Ordinance No. 6;
- KTB management was recommended to immediately seek a liquidity support for the bank from the bank's major shareholders;
- KTB management was recommended to start consultations with the government in order to study the possibility for receiving a liquidity support under the EU terms and conditions for provision of a state aid.

On **20 June 2014** the BNB received a written notice (letter No.4098) from the KTB management:

- informing that KTB liquidity had been depleted and the bank had suspended making payments and conducting all types of banking transactions;
- requesting the BNB to take the necessary measures, including the placement of KTB under special supervision.

By that time no other written notices or requests from KTB had been received.

At around 11:58 am on 20 June 2014 the balance on KTB account in RINGS (Real-time Interbank Gross Settlement System) was BGN 237,773, while queued payment orders exceeded BGN 38 million.

Pursuant to a decision by the BNB Governing Council:

- KTB was placed under special supervision for a period of three months;
- conservators were appointed at the bank;
- the execution of all KTB obligations was suspended and all bank's activities were prohibited;
- the members of KTB Management and Supervisory Boards were dismissed from office;
- the voting rights of the shareholders holding more than 10 per cent of KTB shares, namely Bromak EOOD and Bulgarian Acquisition Company II S.a.r.L, were revoked.

At a BNB press conference enjoying a strong media interest, the Governing Council of the BNB announced its decision.

At the end of 20 June 2014, by letter No. 78077 a written notice was received at the BNB by the CB Victoria EAD management, which:

- informed the central bank that the bank's liquidity was depleted and effective as from 2:42 pm on 20 June 2014, the bank stopped paying in cash and on account sums exceeding BGN 200,000, with the last such transfer executed at 3:31 pm;
- requested the BNB to take the necessary measures, including the placement of CB Victoria under special supervision.

At 4:01 pm on 20 June 2014 the balance on the bank account in RINGS (Real-time Interbank Gross Settlement System) was BGN 7,011,000. Queued payment orders with value dates 20 June, 23 June and 24 June exceeded BGN 27 million.

Pursuant to a BNB Governing Council decision of **22 June 2014**:

- CB Victoria was placed under special supervision for a period of three months;
- conservators were appointed at CB Victoria;
- the execution of all CB Victoria obligations was suspended and all bank's activities were prohibited;
- the members of CB Victoria Management and Supervisory Boards were dismissed from office;

- the voting rights of the shareholders holding more than 10 percent of CB Victoria shares, namely KTB holding 100 per cent, were revoked.

The BNB announced that the liquidity shortage in KTB and CB Victoria was an isolated case and was not connected with the operation of other banks in the banking sector.

Following intensive consultations with the government and parliamentary represented political parties, on Saturday and Sunday, 21 and 22 June 2014, and the analysis of various options, the BNB proposed the following actions which were planned to be taken with the support of the government:

- conservators were instructed to organize and prepare an analysis and assessment of KTB and CB Victoria assets and liabilities by an independent external auditor for a period of ten days;
- a write-off, where necessary, of KTB shareholders' equity and revocation of their rights in line with the procedures provided for by law;
- with a view to safeguarding KTB activities in its recovery– an increase of KTB capital and its subscription by the Bulgarian Development Bank and the Deposit Insurance Fund;
- provision of liquidity support, where necessary, to KTB in order to entirely meet bank's obligations to its customers.

To provide greater certainty around the capital adequacy, three large audit firms were appointed to conduct a ten-day review of KTB and CB Victoria assets and liabilities. It was planned the KTB review to be performed jointly by Deloitte Audit OOD, Ernst & Young Audit OOD, and AFA OOD, while that of CB Victoria – by AFA OOD.

The above actions had to be undertaken by 20 July in order for KTB and CB Victoria to open for business on 21 July 2014 at 9:00 am.

The decision to place these banks under special supervision was motivated by the liquidity pressure on them and the inability to meet their obligations. According to the supervisory reporting of KTB to the BNB Banking Supervision Department, its total capital adequacy was 13.71 per cent at the end of the first quarter of 2014. At the same time, however, the situation around KTB as reflected by media, raised doubts as to the quality of the assets and the bank capital adequacy respectively.

Despite the above actions, the BNB was ready at any moment to review any legally acceptable proposals on the recovery of the bank by its shareholders. However, no proposals were submitted.<sup>3</sup>

---

<sup>3</sup>Details of communication with major shareholders are presented in a separate section.

In a press release of **23 June 2014**, the government confirmed its support to the measures undertaken by the BNB in respect of KTB. It was announced that all measures were prepared jointly and in coordination with the government, the Ministry of Finance and the BNB.

On **25 June 2014** the review of KTB and CB Victoria assets was launched.

The review was partial intended to find a prompt resolution of the situation related mainly to the credit and investment portfolios. The time limit of this review was ten business days and the scope comprised 95.4 per cent of the credit portfolio and 99.1 per cent of the investment portfolio of KTB, as well as a partial analysis of bank's liabilities. The review of CB Victoria had an analogous scope.

On **30 June 2014** the BNB Governing Council made a decision to cut deposit interest rates of KTB and CB Victoria to the average market levels of the banking system by type, maturity and currency.

At the **11 July 2014** meeting of the Parliament's Budget and Finance Committee, the BNB presented major results of the ten-day review of KTB and CB Victoria assets along with the measures which had to be undertaken.

As regards CB Victoria, the review confirmed the good quality of the credit portfolio and its collateral, as well as availability of all required provisions. The results show good banking practices in managing credit risk at the bank.

As regards KTB, auditors were able to assess slightly over one-third of the credit portfolio. They were unable at that stage to express an opinion on a credit portfolio of around BGN 3.5 billion (comprising approximately 60 per cent of the total credit portfolio). It was difficult for the auditors to assess the financial position of the debtors and their capacity to service their loans to KTB. It was also difficult to assess the availability and quality of the items of collateral. The inability to give an assessment is due to the fact that significant parts of credit files were missing. There was evidence that documents had been destroyed in the days prior to the placement of the bank under special supervision, though other reasons for the missing documentation could exist.

On the basis of these results it was found that no assessment of the asset quality, and hence the effect on KTB capital adequacy, could be obtained.

As the liquid assets have been exhausted or unavailable and the capital adequacy could not be identified, it was impossible to provide liquidity to KTB neither by the central bank as a lender of last resort under Ordinance No 6 of the BNB (for which liquid assets as collateral with the central bank are required), nor by the state (due to the requirement for a state aid within EU to be provided only to solvent and economically viable banks).

The BNB and the government made a conclusion that the initial plan including government equity participation in the KTB capital was not justified due to the

incomplete information and insufficient data on the quality of KTB assets. The prospect of a bank with an unclear quality of assets, and the resulting possible significant shortfall of capital, to be nationalized involves paying a high price and assuming risks by the taxpayers.

Therefore, the initial plan was dropped and the BNB together with the government and experts of the major parliamentary represented political parties drafted a new one. We would like to emphasise that the new plan has initially found support at an expert level among the major parliamentary parties.

The main idea of the new plan was to separate the assets which had been assessed as good and income-generating, as well as the liabilities of KTB, except for those connected with the major shareholder, and to transfer them to the balance sheet of CB Victoria. Thus, depositors could obtain access to their accounts and normal banking services on the initially announced date (21 July 2014).

This plan contained a number of technical details which included the following measures:

- Buying by the state of CB Victoria at the price at which KTB had acquired 100 per cent of CB Victoria shares;
- A transfer of all good-quality assets and liabilities of KTB to CB Victoria. The latter would involve the deposits, except for those of the major shareholder and connected parties which would not be covered by the state and would remain at KTB. In such a way, CB Victoria would be separated as a “good” bank;
- Provision of liquidity support to the “good” bank by using Deposit Insurance Fund resources to pay the guaranteed deposits at KTB, including state budget funds for covering the shortage in the Fund in compliance with the rules for provision of state aid within the EU and employing mechanisms coordinated with the institutions involved in this process, including the Ministry of Finance and the BNB;
- Revocation of the KTB license and starting insolvency proceedings. The State, through the Ministry of Finance, and the Deposit Insurance Fund would be the privileged creditors in the insolvency.

During consultations in Brussels on **8 July 2014**, the major parameters of the plan were informally consulted with the representatives of the European Commission (Directorate General for Competition), including an option for covering deposits of above the guaranteed threshold of BGN 196,000. An understanding was achieved that the plan would prevent the widespread uncertainty among depositors of other banks, limiting the negative effects for the whole banking sector.

On 14 July 2014 the European Bank for Reconstruction and Development (EBRD) sent a letter expressing its readiness to take part in such a plan provided that the separate “good” bank is in a healthy enough financial situation and the major political forces in tandem with the BNB reach an agreement on the strategy for resolution of the KTB case. So far, we have not informed the general public in Bulgaria about the interest expressed by the EBRD as no political agreement was reached. However, the leaders of political forces were informed thereof at the meeting with President Plevneliev on 14 July this year.

The above measures could have been implemented only after the adoption by the National Assembly of new legislation providing for new bank resolution instruments. The reason is that the existing legislation in Bulgaria (including in the area of special supervision) is limited and does not contain most of the instruments for bank recovery and resolution. Such instruments are provided for in the new EU directive establishing a framework for the recovery and resolution of credit institutions<sup>4</sup>, which must be transposed into national law in the EU Member States until the end of 2014.

Thus, in addition to the technical expertise in drafting the new plan, the BNB and the government made a legislative proposal formulating new bank resolution instruments. The draft proposal was presented to the major parliamentary political forces.

During several media events of **11 July 2014**, including at the meeting of the Budget and Finance Committee in the 42nd National Assembly, the BNB drew attention to the need of joint efforts and consensus of all political parties represented in the Parliament. Without consensus and adoption of a new legislation introducing bank resolution instruments, the KTB plan could not be implemented.

On **14 July 2014** the President of Bulgaria initiated a meeting on the state of the banking system and KTB in particular. Leaders of parliamentary represented parties (excluding the Ataka political party), the Prime Minister, the Minister of Finance, and the Governor and Deputy Governors of the BNB attended the meeting. It appeared that the political forces could not reach an agreement during the discussion to support the plan proposed by the government and the BNB<sup>5</sup>. No consensus was reached on the matter of whether the existing legislation should be followed, or a new special law should be adopted.

---

<sup>4</sup> Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU, and Regulations (EU) No 1093/2010 and (EU) No 648/2012 of the European Parliament and of the Council.

<sup>5</sup> In this period, political parties had practically started their campaign for early parliamentary elections on 5 October.

In its statement after the meeting, the President outlined that the existing Bulgarian legislation in the financial sector is working well, consistent with good European practices and provides for clear mechanisms of action.

Hence, since that moment on, the BNB has continued to act within the framework of the existing legislation, and the possibilities to open KTB and CB Victoria on 21 July (the term agreed between the government and the BNB) were exhausted. From that moment on, any decision had to be based on a new, detailed and undisputed assessment of the KTB asset quality.

In a press release of **15 July 2014**, the BNB stated that given no agreement existed on the legislative approach proposed by the central bank and the government, the BNB would continue to work under the special supervision procedure consistent with the requirements of the Law on Credit Institutions.

In addition, it was announced that the term of the special supervision might be extended beyond the initially set three-month period.

In compliance with the requirements of Article 121 of the Law on Credit Institutions, on **25 July 2014** the conservators of KTB submitted a report on the current position of the bank. Together with that report, the unaudited financial statements of the bank as of 30 June 2014 were also presented.

The bank's financial result as of 30 June 2014 was a loss of BGN 65.3 million, which was fully accounted for by the loan portfolio impairment costs incurred during the month. The conservators noted in the report that these impairment costs were determined according to the current KTB procedures and internal rules for determining impairment on a portfolio basis, which do not ensure full compliance with the main requirements under the International Financial Reporting Standards (IFRS) due to the lack of assessment of large individual exposures. In addition, conservators pointed out that the use of the current bank rules for determining impairment on a portfolio basis would lead to faster accumulation of impairments only on the basis of the current position without an individual assessment of the quality.

Based on the unaudited financial statements, the bank's overall capital adequacy as of 30 June 2014 was 10.54 per cent, and the Tier 1 capital adequacy was 7.86 per cent.

The report on the current position of the bank provided a detailed list of conservators' activities in performance of their obligations under the Law. All actions concerning the ongoing management and control of the bank's activities under the special supervision had been undertaken. Implementation of the decisions of the BNB Governing Council had been ensured. At the same time, adequate actions were implemented to protect the bank's interests both in its relations with debtors and with regard to creditors. A lot of meetings were conducted with a number of debtors and creditors.

Conservators determined as fundamental the issue of the need of making a reliable assessment of the loan and investment portfolios of the bank, which would correspond to the current position of borrowers and issuers and would be compliant with the IFRS.

Taking into consideration the information included in the report on the current position of the bank and in accordance with the existing legal procedures for special supervision, on **31 July 2014** the Governing Council of the BNB issued the following mandatory instructions to the KTB conservators:

- to set up a special team which, by 15 September 2014, must organise the preparation of the credit files for the purposes of the asset analysis and assessment, and must assist the conservators in managing the relations with borrowers, including for implementation of the actions needed to be taken with regard to debtors who do not service their obligations to the bank regularly;
- to sign a contract for legal advice on the collateral review as part of compiling and preparing the credit files;
- to sign additional contracts with the audit firms – Ernst and Young Audit OOD, Deloitte Audit OOD, and AFA OOD – for preparing a thorough assessment of the bank's assets, to be completed by 20 October 2014;
- to propose to the BNB a draft invitation to the shareholders to declare their interest in, and possibility of, providing both capital and liquidity support to KTB;
- By 20 August 2014 they must make changes to the internal rules and procedures for determining the impairments of credit exposures with a view to determining, on an individual basis, impairments of exposures with significant defaults, thus ensuring full compliance with IFRS;
- By 5 September 2014 the conservators must provide the BNB with information about the progress on the fulfilment of the above prescriptions.

On **15 August 2014** the BNB Governing Council permitted KTB and CB Victoria to carry out:

- payment operations for repaying loans to a bank under special supervision, from accounts with the same bank of the borrower, of his/her co-debtor or surety when the co-debt or suretyship was created before 1 June 2014;
- cashless foreign currency exchange transactions when these are needed for repaying loans.

On **16 September 2014** the BNB Governing Council made a decision to extend the term of special supervision of KTB and CB Victoria by another two months to 20 and 22 November 2014, respectively.

In a press release on the same day, the BNB announced the reasons for its decision, stating that to date the conditions that had led to placing KTB AD under special su-

pervision were still in place. The bank continued to face severe shortage of liquidity for meeting its obligations to depositors and other creditors which amounted to BGN 6,227,521,000 in total as of September 2014, and for CB Victoria EAD, they amounted to BGN 285,786,000.

The BNB also reiterated that prior to making a clear assessment of the quality of assets and the capital adequacy of KTB AD, it was not possible to make any economically substantiated and legally binding decisions on the bank's future. Based on the result of the assessment of KTB assets, its capital adequacy ratio and declared meanwhile investment intentions of EPIC (European Privatization & Investment Corporation), the final decision with regard to KTB AD must be made in the period between 1 November 2014 and 20 November 2014.

As regards CB Victoria EAD, the BNB announced that:

- In view of the fact that KTB has been placed under special supervision for reasons of liquidity shortage, it cannot provide liquidity support to its subsidiary bank CB Victoria EAD. Respectively, CB Victoria does not have liquid assets eligible under BNB Ordinance No 6 against which it could receive liquidity from the BNB pursuant to the lender-of-last-resort rules.
- Regardless of the fact that the assessment of assets and supervisory reports of CB Victoria indicate that to date the bank meets the regulatory requirements for capital adequacy, the bank cannot be granted state aid because the authorization of such aid by Directorate General for Competition of the European Commission requires that CB Victoria be considered as part of the KTB group and the requirements for state aid must be fulfilled at the group level. At this stage, however, in view of the lack of clarity regarding the KTB capital adequacy, it is not possible to prove to the EC that KTB has a sufficient level of capital adequacy to apply for state aid.
- Currently, the only source of liquidity support to CB Victoria is the sale of non-liquid assets – a credit portfolio. Based on this, instructions were given to CB Victoria conservators to take the following actions:
  - preparations for conducting a tender procedure for the sale of separate portions of the bank's credit portfolio aiming to ensure the necessary liquidity for repayment of the bank's obligations to depositors and creditors. In view of this, CB Victoria conservators have drawn up a draft agreement with the consultant Ernst & Young OOD and a draft invitation for participation in the tender procedure for a sale of separate portions of the bank's credit portfolio;
  - streamlining administrative expenses;
  - ensuring operational independence by revising the existing contracts for IT and accounting systems support, and possibly signing of new contracts

which are warranted in view of the complexity of the bank's business model.

- In relation to the tender procedure and banks' indicative offers for the sale of separate portions of CB Victoria's credit portfolio, the BNB Governing Council issued mandatory instructions to the conservators:
  - to send, by 23 September 2014, invitations to the banks for participation in the tender procedure for a sale of a separate portion of the bank's credit portfolio and, if interest is manifested, to ensure submission of the final offers no later than 15 October 2014;
  - to submit to the BNB, by 20 October 2014, a report on the offers received with information whether the highest offered price covers all CB Victoria's obligations to creditors and depositors and for what term.

On **20 October 2014** KTB conservators submitted to the BNB a report on the analysis and assessment of KTB's major balance sheet items and bank guarantees issued by the bank to its customers, conducted by Ernst & Young Audit OOD, Deloitte Bulgaria OOD, and AFA OOD.<sup>6</sup>

At its **21 October 2014** meeting, the BNB Governing Council adopted a report on the analysis and assessment of KTB assets, conducted by Ernst & Young Audit OOD, Deloitte Bulgaria OOD, and AFA OOD in the period from 5 August to 20 October 2014.

The analysis and assessment of the assets were based on the principles of recognition and assessment in compliance with the applicable International Financial Reporting Standards. The assessment was based on the assets and bank guarantees entered in the bank's records as of 30 June 2014, reflecting all significant events by 30 September 2014 that affect the analysis.

As of 30 September 2014 the total assets of the bank amounted to BGN 6662 million. The audit firms concluded that the assets of the bank needed to be impaired by BGN 4222 million in total.

The following analytical table displays KTB's balance sheet as of 30 September 2014 prior to recording the outcomes of the analysis and assessment by the audit firms Ernst & Young Audit OOD, Deloitte Bulgaria OOD, and AFA OOD:

---

<sup>6</sup> The BNB is not a party to the contracts between the KTB conservators and the audit firms, and the reports may be disclosed only with the auditors' permission and under conditions stipulated by the auditors.

(book value in million. BGN.)	30 June 2014	30 September 2014
<b>ASSETS</b>		
<b>Cash and cash balances held with central banks</b>	<b>144</b>	<b>331</b>
<b>Securities</b>	<b>775</b>	<b>598</b>
including:		
Government securities – Bulgarian	381	207
<i>of which: pledged in favour of the state budget</i>	112	113
<b>Loans and receivables</b>	<b>5 541</b>	<b>5 606</b>
including: corporate ones	5 500	5 522
<b>Other assets</b>	<b>435</b>	<b>128</b>
<b>TOTAL ASSETS</b>	<b>6 896</b>	<b>6 662</b>
<b>LIABILITIES</b>		
Deposits from credit institutions	154	224
Deposits from financial institutions	343	363
including: Liabilities under a corporate securities issue	220	239
<b>Deposits from budget-supported organizations (secured with government securities)</b>	<b>96</b>	<b>100</b>
Deposits from non-financial corporations	1 220	1 199
including:		
from state-owned and municipal corporations	352	378
from other public corporations	34	35
from private corporations	813	766
Deposits from individuals and households	4 304	4 371
Including		
from residents	4 068	4 132
from non-residents	210	213
from NGOs	26	26
Other liabilities	56	2
Total funds attracted from customers	6 173	6 260
Subordinated debt	202	205
Capital	521	198
<b>TOTAL LIABILITIES AND CAPITAL</b>	<b>6 896</b>	<b>6 662</b>

The main changes in the bank's balance sheet reflect repayments received in the period, interest accrued but not paid on the bank's assets and liabilities, reclassification of exposures and consolidation of funds.

The bank's highly liquid assets (funds in accounts held with the central bank and in cash) as of 30 September 2014 were BGN 331 million. The BGN 187 million increase compared to 30 June 2014 is the result of transferring into accounts with the BNB of funds held in correspondent accounts with commercial banks and receipts from principal and interest repayments.

Impairment costs arising from revealed losses and reclassification of exposures were accrued in the period, as follows:

1. The biggest losses result from the accounting transaction effected on 20 June 2014, reflecting the cash withdrawal of BGN 206 million against the obligation assumed, and defaulted on, by Bromak EOOD to repay the funds on 30 June 2014, which was posted as an asset in the form of this receivable. For it, there are practically no clear grounds, neither for its actual occurrence, nor for its real collectability by the bank. Therefore, its value is zero in accordance with the asset recognition standards under the International Financial Reporting Standards (IFRSs).
2. During the period under review, another such transaction was found out. As a result of lending of government securities in the amount of EUR 80 million to Technology Center – Institute of Microelectronics AD (TC-IME AD), which it is neither in the position to repay (or reimburse), nor alternatively to pay the remuneration due, the amounts reported as part of an investment portfolio of government securities were reclassified into a receivable from TC-IME AD. As the company is under bankruptcy proceedings and the probability of collecting this receivable is minimal, it was 100 per cent impaired.
3. The book value of the loan portfolio as of 30 September 2014 reflects impairments amounting to BGN 148 million, which were determined on a portfolio basis in accordance with the impairment loss determination policy in effect until 20 August 2014.

The practice of determining losses from impairment of exposures was based entirely on the concepts of BNB Ordinance No 9, revoked in April 2014. After its revocation, no actions were pursued by the bank to establish a new policy for determining impairment losses in line with the rules of International Accounting Standard 39. The impairment loss determination policy applied by the bank allowed for reporting low impairment costs, as the loans were reported as “standard without arrears”, without clear information of the sources of funds used for repayment; hence, they were formally assessed on a portfolio basis with minimum expectations of impairment losses. A test conducted in the bank, taking into consideration actual arrears, indicates that the formal application of this policy would have resulted in loan portfolio impairment losses amounting to BGN 4757 million as of 30 September 2014.

With a view to eliminating the established weaknesses in the bank's policy for determining losses from financial asset impairment and the methods for its implementation, the conservators have taken steps to update and supplement the bank's policy

for determining losses from impairments of financial assets. Thus, a fairer and more reliable measurement of the real rate of return on individual credit exposures, made on an individual basis at that, taking into account all valid and enforceable items of collateral, is achieved. This further development of the policy was combined with a number of activities for broad-based updating of existing information – financial, non-financial and legal – about borrowers, investments, and issued guarantees, as well as of the collateral provided in favour of the bank.

In fulfilment of BNB Governing Council's decision of 31 July 2014, KTB conservators assigned the audit firms Deloitte Bulgaria OOD, Ernst and Young Audit OOD and AFA OOD to make an analysis and assessment of main balance sheet items (including of a sample of loans, investment portfolio, securities, other assets, real estate) and bank guarantees issued by the bank, with a deadline 20 October 2014. The same decision mandates the conservators to set up a task force to prepare the credit files for the purpose of the audit assessment and to assist conservators in managing relations with borrowers.

In line with the scope specified in a Letter of Commitment, the above mentioned audit firms performed an analysis and assessment of the main balance sheet items (including of a sample of loans, investment portfolio, securities, other assets, real estate) and bank guarantees issued by the bank. The analysis performed is based on the underlying principles of recognition and assessment of applicable IFRS. The assessment is based on the assets and bank guarantees entered in the bank's records as of 30 June 2014, while reflecting all significant events with impact on the analysis as of 30 September 2014. For this purpose, the information collected by the bank and available was used by taking into account any additional relevant information as of other subsequent dates, but no later than 30 September 2014. The analysis and assessment were made under the assumption of preserving the bank as a going concern. The applied methods and techniques of determining and calculating the necessary credit portfolio depreciation are based on both IFRS and the good practices applied by the European Central Bank.

Already prior to the start of the audit firms' work, the bank's conservators organized the process of collecting additional information, the need of which was identified during the preliminary review of assets conducted by the same firms over the period 25 June 2014 – 8 July 2014. Borrowers were requested to furnish detailed lists for providing historical and forecasted information, and those failing to submit the full set of information were reminded of this through a number of letters. Additional information was collected also as a result of additional meetings and conversations with borrowers whom conservators managed to contact. Furthermore, legal opinions on the validity of collateral items were prepared and, where necessary, updated assessments of valid collateral items were made.

The outcomes of the analysis and assessment are, as follows:

<b>Balance sheet item</b>	<b>Value according to the bank's registers as of 30 June 2014</b>	<b>Value according to the bank's registers as of 30 September 2014</b>	<b>Necessary impairments based on the analysis and assessment</b>
<b>As per sample</b>	<i>BGN million</i>	<i>BGN million</i>	<i>BGN million</i>
Loans granted to non-financial institutions and other customers (loan portfolio)	5 301	5 335	-4 057
Investments available for sale (investment portfolio)	380	376	-144
Securities (investments) held for trading (trading portfolio)	11	9	-0
Other assets	353	141	-3
Property owned by the bank	60	59	-18
Investment in CB Victoria	5	5	0
<b>Total amount</b>	<b>6 109</b>	<b>5 925</b>	<b>-4 222</b>

For assessment purposes KTB's assets were subdivided into the following groups: a credit portfolio, investment portfolio (bonds and shares), portfolio of securities held for trading (bonds), issued bank guarantees and letters of credit, real estate (buildings and land) and other assets, including the investment in the subsidiary bank CB Victoria EAD. The work performed by the audit firms has produced the following summarised results:

The assessment of the bank's credit portfolio includes the exposures of 138 borrower companies with total liabilities of BGN 5,335 million as of 30.09.2014, or 96.6 per cent of the total corporate loan portfolio. The conclusions from the analysis and assessment made by the three audit firms are very similar and can be summarised as follows:

1. With regard to 14 borrowers with a total amount of exposures of BGN 441 million there are no indications of impairment or the impairment is minimal. Although in five of the cases no significant valid collateral items have been established, the companies' financial standing gives grounds to conclude that for this group impairments of BGN 46 million will be needed.
2. With regard to 29 borrowers with a total amount of exposures of BGN 888 million, operational activity has been established the results of which do not sufficiently support the servicing of its loans. These companies have shown significant indications of deteriorating financial health (consistently declining incomes and/or profits; loss from activities; negative own funds, *etc.*) and/

or businesses whose line and scope of activity are incommensurate with the amount and purpose of the extended loan; for four of the companies no valid collateral has been identified. Overall for this group the conclusion is that impairments of BGN 594 million are required.

3. A group of 6 borrowers with a total exposure of BGN 377 million can be identified as companies with operational activities with a high level of business dependency on few connected persons. Overall for the group, impairments of BGN 216 million are needed.
4. The largest group of 82 borrowers includes borrowers, which for the most part (67 cases) have no operational activities of their own, or very limited operational activities, and their incomes are generated entirely or mainly by third parties. The total exposure of all the companies from the group is BGN 3,434 million or 64 per cent of the loan portfolio.

These are companies and holding companies whose core activity lies primarily in the investment business, and in many cases they are without own staff and other operational activities. Many of them are newly set up (i.e. established no earlier than 12 months before the first loan was extended) or companies whose purpose is acquiring interests and shares in other companies. In the majority of credit files of borrowers of this group, no detailed business plans were found out, or other information supporting the economic feasibility of extending the loans, expected cash flows of borrowers or sources of loan repayment. For most of the credit files no documents are available, certifying whether the loan was utilised according to the purpose described in the loan agreement.

Collateral on these loans are pledges of tangible assets, future receivables with payments into the borrower's bank accounts with the bank, shares of acquired enterprises or companies. As a result of the legal analysis, the prevailing portion of these collateral items turned to be either with omissions in their establishment or non-existent, which makes them impossible to realise. As of 30.09/2014, as a result of the analysis of borrowers in this category, the ratio of debt coverage with valid items of collateral, given their recoverable value, is just around 2 per cent.

According to the balance sheets of borrowers in this group, where such are available, a large portion of them report substantial claims on third parties, or investments in other enterprises. In the course of work on the analysis and assessment, conservators requested many times detailed information on these assets in order to estimate the borrowers' potential to realise them and thus ensure the necessary cash flows to service the loans. Despite the multiple requests by the conservators for further information on these assets, borrowers did not supply all the requested information or any information at all.

Loans of BGN 1,394 million to borrowers in this group were renegotiated many times, and the terms for their repayment were extended. Servicing of

the prevailing portion of these loans, in terms of both principal and interest, was halted with the bank's placement under special supervision, and as of 30.09.2014 there were significant arrears.

Given these significant deficiencies of the loans in this group, the lack of important information needed for credit risk assessment, and the bank's inability to obtain such information during the analysis and evaluation, the auditors came to the conclusion that there was no evidence confirming that the bank exercises or could get control over the benefits of these companies' assets. Therefore, according to the auditors, those loans had to be fully impaired, taking into account the valid items of collateral, if any. Based on the assessment, the conclusion is there are grounds for charging this group a significant impairment of BGN 3,021 million.

5. Another group of borrowers with similar ability to service their loans is that of 5 companies which, though operating, have not achieved results enabling them to service their loans, and the valid collateral, if any, is of limited value. That group's exposure of BGN 172 million would require impairment of BGN 166 million.
6. Two companies form a separate group, as insolvency proceedings have already been initiated for them, and the expected loss is estimated at BGN 14 million.

Altogether, as of 30.09.2014 the total gross book value of the loans in the sample amounted to BGN 5,335 million and the loan impairment for them was estimated at BGN 4,057 million.

The securities portfolio was also analysed and assessed based on the applicable IFRSs for recognition and assessment, and on the available and collected additional information on securities markets and issuers. Fourteen exposures in corporate securities were evaluated, with an active market for five of them. Out of the ones with no active market, four were measured at fair value based on a model, and three others were measured at fair value reduced by depreciation. In the individual cases where the issuers were borrowers too, the auditors also took into consideration the quality assessment of their credit exposures to the bank. The conclusion from the audit firms' reports is that securities impairments totalling BGN 144 million are needed.

As for the other assets covered by the audit firms' review, including real estate and bank guarantees, the auditors concluded that an impairment of BGN 30 million was needed, in accordance with the applicable IFRSs.

Based on the bank's balance sheet and the outcomes of the analysis and assessment of main balance sheet items (including a sample of loans, an investment portfolio, securities, other assets, real estate) and bank guarantees issued by the bank, the following conclusions can be drawn:

After the bank was placed under special supervision, many omissions, made earlier before the special supervision, were found out:

- In the lending process, there were no in-depth checks of loan applicants, no complete analyses of business plans and estimates for the projects, as grounds for extending the loans.
- There was no control over the establishment and on-going monitoring of the agreed collateral. The analysis indicates that a prevailing portion of these collateral items had been established with omissions or were non-existent, which made them impossible to realise. The coverage ratio of the bank's loan portfolio with valid collateral is around 13 per cent.
- There was no ongoing monitoring and control over the borrowers' business and if the loans granted were used to purpose. Loans were repeatedly renegotiated without evidence substantiating the need for that.
- The documentation kept in the credit files was not maintained in a way allowing the bank to manage its receivables so as to obtain the economic benefits from them.
- In its activities the bank followed wrong business practices that are unconventional for the banking system, carrying out complex operations aimed to conceal the nature of deals and transactions. One such example is the specific way of lending intermediated by "special purpose vehicles", holding companies and other similar companies, to finance the purchase of assets, which is inconsistent with the standard and sound banking practices.
- The financial and supervisory reports submitted by the bank's management to the BNB Banking Supervision Department before the bank was placed under special supervision were untruthful and misleading.

The bank's management has not followed prudent and conservative banking practices.

For the above reasons, the BNB sent the auditors' reports to the attention of the Sofia City Prosecutor's Office.

On **21.10.2014**, the BNB Governing Council made the following decision:

- instruct the conservators to post in accordance with IFRSs in the bank's balance sheet the results of the assessment and analysis of KTB's assets as of 30.09.2014;
- instruct the conservators by 31.10.2014 to submit to the BNB Banking Supervision Department the relevant financial and supervisory reports, needed for making the decisions as provided for in the Law on Credit Institutions.
- 27.10.2014, the first working day of the 43<sup>rd</sup> National Assembly, in order to

assist the work of the Members of Parliament and to take an informed decision on the KTB case, the BNB Governing Council should submit to the National Assembly summarised information of the events and of all actions undertaken by the BNB with regard to KTB and CB Victoria EAD – from 20.06.2014 (the day when KTB was placed under special supervision) to 27.10.2014.

**Based on the data from the analysis and assessment, and on the conclusions drawn by the audit firms as to the required impairments, KTB is expected to report to the BNB Banking Supervision Department negative own funds.**

**The actions of the relevant institutions and their sequence after receiving the financial and supervisory reports follow the provisions of the existing legal framework:**

- **Legal obligation to withdraw the license of a bank with negative own funds (pursuant to Art. 36, paragraph 2, item 2 of the Law on Credit Institutions).**
- **Decision to withdraw a license is made within 5 business days from establishing insolvency, *i.e.* from receiving the supervisory reports indicating the negative own funds of KTB (according to Art. 36, paragraph 3 of the Law on Credit Institutions).**
- **Petition to the competent court for initiation of bankruptcy proceedings for KTB (pursuant to Art. 37, paragraph 2 of the Law on Credit Institutions).**
- **Within 20 business days from the date of the decision to withdraw the bank's license, the Bulgarian Deposit Insurance Fund starts paying deposits up to the guaranteed amount (pursuant to Art. 23, paragraph 5 of the Law on Bank Deposit Guarantee). In exceptional circumstances, the Fund may extend this term by not more than 10 business days (pursuant to Art. 23, paragraph 6 of the Law on Bank Deposit Guarantee).**
- **The Bulgarian Deposit Insurance Fund pays out the guaranteed amount of bank deposits via a commercial bank/commercial banks, designated by its Management Board. Within 7 business days prior to commencement of payments of guaranteed amounts, the Management Board of the Bulgarian Deposit Insurance Fund is obliged to announce in at least two major dailies the date from which depositors can receive the guaranteed amounts and the bank via which these payments will be effected (pursuant to Art. 23, paragraphs 2 and 4 of the Law on Bank Deposit Guarantee).**

**Decisions and actions by the BNB and/or by the Bulgarian Deposit Insurance Fund other than the ones described above, including any such related to the restructuring of KTB, will be possible only if the National Assembly, within its legislative competences, would find it appropriate to and forthwith adopt amendments and supplements to the existing legislation, including with regard to the required provision of resources.**

### **III. PURPOSE, SCOPE AND CONCLUSIONS OF THE SUPERVISORY INSPECTION IN CORPORATE COMMERCIAL BANK CONDUCTED IN THE PERIOD 7.07. – 14.10.2014, BASED ON DATA AS OF 30.06.2014**

In parallel with the assignment of a review of the assets of KTB AD by the three audit firms – Deloitte Audit OOD, AFA OOD and Ernst & Young Audit OOD – the acting Deputy Governor in charge of the Banking Supervision Department ordered an on-site inspection at the bank. The on-site inspection was conducted in the period 7.07.–14.10.2014 based on data as of 30.06.2014. The inspection team was 22-strong, which is a precedent, as the standard supervisory inspection teams usually consist of 3–6 people.

The inspection was conducted in three stages, the scope and purposes of which were as follows: **Stage 1** – establishing the completeness of credit files subject of the last supervisory inspection (based on data as of 31.03.2013) and comparing their content with the content of the same files as of 30.05.2014; **Stage 2** – assessment of the administration of credit files of loans extended after 31.03.2013, and of loan transactions falling outside the sample reviewed by the latest supervisory inspection conducted of data as of 31.03.2013, but included in the sample of the three audit firms making the asset review; **Stage 3** – tracing cash flows in relation to utilisation of the funds extended under the loans and servicing them; probable connectedness between the borrowers from the bank’s loan portfolio; origin of the funds for increase of the shareholders’ equity and the issue of other equity instruments included in the institution’s capital.

#### **Establishing the completeness of the credit files subject to review by the latest supervisory inspection ended in June 2013.**

During this stage the inspection reviewed 146 credit files of 66 borrowers from the bank’s loan portfolio as of 31.05.2014 with total pre-impairment balance sheet value of BGN 2,481,303,000 and compared their current content with the content as of June 2013. The comparison made by the inspection of the content of the same credit files reviewed in June 2013 found out that in 54 per cent of the inspected sample of loans, in the files there are missing documents in relation to: the current financial position of debtors; documents proving the availability of collateral, failure to register the registered pledges of borrowers’ items of collateral where such were created in favour of the bank; documents proving the due creation of pledges in favour of the bank of various assets indicated as loan collateral; documents proving the purpose for which the funds from the loan transaction were spent.

Such findings of gaps in the credit files from the inspected sample were not made in the report from the supervisory inspection made as of June 2013.

### **Review and assessment of administration of credit exposures**

For the purpose of performing this task, a review was made of the movement of funds on current and loan accounts of 91 borrowers having 208 loans with gross pre-impairment value as of 30.06.2014 of BGN 3,710,407, 000, or 67 per cent of the bank's loan portfolio amounting to BGN 549,240,000.

Almost all loans from the sample were serviced in line with the agreed repayment plans (98.28 per cent of the inspected sample) and the first past due principal and/or interest payments were as of end-June 2014. In the same month annexes were signed for part of the loans with the purpose to postpone the payment of due repayment instalments for a three-month term (with total gross book value of BGN 1,067,294,000, or 28.76 per cent of the sample). From this finding the conclusion can be made that with its approach the bank has permitted certain borrowers to conceal their inability to repay their obligations, which has led respectively to submission to the BNB of untrue information as regards the quality of these loans.

In the inspection process it was found out that a prevailing part of inspected exposures were granted for investments (with gross book value of BGN 2,956,188,000, or 77 per cent of the sample), including for purchase of shares or stakes of third parties (total gross book value of BGN 1,213,350,000).

The review of credit files as part of the supervisory inspection at the bank identified the following omissions in terms of their administration: **1)** lack of sufficiently detailed substantiation in the loan opinions and monitoring reviews for the purposes of approval and subsequent renegotiation of transactions – insufficient information in writing, substantiation and data of the objects of activities, business and competition environment, specific data regarding financing, analysis of customers' creditworthiness, analysis of the level of relatedness of persons, *etc.*; **2)** lack of information and in-depth analyses of the sources of funds for loan repayment, particularly in the cases where the borrowers' business was only related with the project financed by the bank; **3)** insufficient collateralisation of loan transactions and/or lack of documents of the due registration of the collateral in favour of the bank; **4)** absence of current financial and accounting reports and/or detailed explanation of items to them, which limits the possibility of analysis of current company information and calculation of financial indicators allowing for reliable assessment of borrowers' financial positions.

The inspection also found out that the financial and accounting reports available in the credit files provided almost entirely refer to prior periods, and only in single cases the files contain reports as of 31.03.2014 or 30.06.2014. The annual financial statements for 2013 or for prior periods are not accompanied by detailed explanations of items of the balance sheets and income statements of companies, based

on which specific trade receivables and obligations can be established. The above finding is also to a great extent true for companies the shares or stakes of which were acquired by borrowers financed by the bank and whose financial position is closely related to the revenues of the acquired companies.

In the process of tracing cash flows to and from the borrowers' current accounts the inspection covered the period from the extension of loan funds to the date of review of the respective cash flows, which in some cases is longer than five years. As a result of the inspection, one is impressed by the existence of a great number of cash flows between a number of companies which are both borrowers or customers of the bank.

The inspection also investigated the cash flows by which some loan exposures part of the sample were repaid. The analysis indicates that 42 per cent of the repayments were funds with initial source disbursed loans, which have passed through several accounts of various companies and were directed via indirect transfers to borrowers of the bank. Hence, the conclusion can be made that with such techniques the bank kept artificially high the quality of a significant portion of its loan portfolio, thus reporting overwhelmingly higher level of serviced loans. This is a misleading and fraudulent practice of loan portfolio quality management, which can hardly be established by a standard on-site supervisory inspection.

Part of the cash flows of TC IME AD, Bromak EOOD and Fina C EOOD, whose most significant transfers go through the accounts of TC IME AD, were investigated. As of 30.06.2014 TC IME AD is not a borrower of the bank. The movements of funds via its lev-denominated current account have been traced for the period from 1.01.2007 to 25.06.2014. The existence of considerable turnover of funds in the range of billion levs was established; part of fund transfers initiated by other companies, including funds from disbursed loans extended by the bank, have passed, though not directly, through the lev-denominated account of the company. At the same time, TC IME AD is a source of funds used for repayment of other companies' loans. This means that wilfully and deliberately funds from the accounts of TC IME AD were used with the purpose of concealing repayments of existing loans with funds from new loans extended by the bank, which is difficult to prove formally under the provisions of the existing legislation. Companies were selected, whose payments were effected through transfers to and from TC IME AD, among which the largest transfers were with the participation of: Crown Media AD, Fina C EOOD, IPS AD, Fina S AD, Bromak EOOD, Technotel Invest AD, Vives AD, Ken Trade EAD, KTB AD, Varna Tower OOD, Balkan Media Group EAD, *etc.*

### **Capital increase**

As a result of the inspection of cash flows and establishing the source of funds for the capital increase in May 2013 (BGN 86,329,000) and under the contracts for provision of subordinated term debt after 5.10.2011 (BGN 183,848,000), it was

found that a significant portion of the funds used to increase the capital of KTB AD in the period 5.10.2011 – 24.03.2014 have as their initial source loans extended by the bank itself.

For the period before the entry into force of Regulation No. 575/2013 from 1 January 2014, the permits for inclusion of subordinated term debt in the Tier 2 capital were issued in accordance with BNB Ordinance No. 8. According to the provisions of Art. 4, paragraph 2, item 3 of the Ordinance, there is no requirement as to the origin of the funds provided as subordinated term debt. Nevertheless, the transactions effected for the increase of the shareholders' equity and of the additional capital (through subordinated loans) cannot be defined as a prudent and conservative banking practice, since they cast suspicions as to the quality and amount of the regulatory capital based on which capital adequacy is calculated. In the current Regulation No. 575/2013 in effect from 1 January 2014, there is an explicit requirement that both common equity Tier 1 (shareholders' equity) under Art. 28, paragraph 1, letter "b" and subordinated loans (included in Tier 2 capital) under Art. 63, letter "c" should not be funded, directly or indirectly, by the banking institution. For proving this circumstance, Art. 1.3 of the subordinated term debt agreement of 24.03.2014 signed by KTB AD and TC-IME AD explicitly states as follows:

"The provision of the subordinated term debt shall not be financed, directly or indirectly, by KTB AD."

Therefore, the management of KTB AD has submitted to the BNB false information with the purpose to obtain a permit for the inclusion of this subordinated term debt in the Tier 2 capital of the bank.

### **Connectedness in the loan portfolio**

In order to find out any existing potential relatedness, the borrower companies, receiving loans from the bank, were analysed. Listed below are the outcomes of the investigation:

- in terms of ownership (a company and person holding more than 10 per cent stakes or voting shares in the company), 29 individual groups of connected persons were identified;
- in terms of control (persons whose business is controlled by a third party or by a third party's subsidiary), 12 individual groups of borrowers were identified;
- in terms of management (persons in whose management or controlling bodies one and the same legal or physical person participates), 59 individual groups of borrower companies were identified. It should be noted that in the above mentioned 59 separate groups of connected persons there are companies with more than one manager (two or three), which results in their inclusion in more than one group of connected persons, or referring to one group more than once as regards management;

- the checks made established that 86 companies – borrowers of the bank were registered at seven addresses, and six of the bank’s employees were registered as managers (in 6 cases) or owners (in 1 case) of seven companies – borrowers of the bank. These exposures do not fall within the scope of regulations under Art. 45 of LCI, therefore there was no legal requirement for them to be reported in the supervisory reports. These techniques allowed the bank to circumvent the legal requirements and conceal the existence of “closely connected” persons that involved common credit risk, thus yet again deceptively maintaining the high quality of its credit portfolio.

According to the existing regulatory framework in effect until the end of 2013 (BNB Ordinance No. 7 on Reporting Large Exposures of Credit Institutions, under Art. 44 and Art. 45 of LCI) the bank should have reported the connected persons, where the overall exposure exceeds 10 per cent of its own funds. To find out if the bank’s annual report under the ordinance is compliant, the correctness of reporting economically connected persons as of 31.12.2013 was investigated. According to loan portfolio data as of 31.12.2013, it was found that 18 groups of connected persons had been formed, the total exposure of each one, before the effect of credit risk mitigation, exceeding 10 per cent of the bank’s own funds. Out of them, two large exposures to groups of connected persons in terms of control (persons whose activity is controlled by third party or by a third party’s subsidiary, in accordance with LCI) were not reported to the BNB, *and the exposures of another two borrower companies were not included in the exposures to connected persons reported by the bank.*

With the entry into force of Regulation No. 575/2013/EU from 1.01.2014, the bank should report to the BNB the occurrence of any large exposure to a person or group of connected persons in accordance with the requirements of Art. 392 of the Regulation, where the value of the group’s exposure exceeds or is equal to 10 per cent of the institution’s eligible capital. Based on the supervisory reports of large exposures provided as of 30.06.2014, it was found that two large exposures were reported separately instead of being reported together with the exposures to the connected persons to which they belong, and one group of connected persons (comprising two companies), whose common exposure exceeds 10 per cent of the eligible capital, was not reported at all.

**The numerous individual groups of connected persons established (based on the above-stated legal criteria) determine as particularly high the risk of concentrations in the bank’s loan portfolio, although none of the common exposures of each individual group exceeds formally the maximum threshold set out in the legislation (of 25 per cent of the bank’s eligible capital).**

In conclusion, all findings and conclusions made in the report of the supervisory inspection conducted in the period 7 July – 14 October 2014, confirm the conclusions

drawn from the reports of 20 October 2014 of the three audit firms as regards the analysis and assessment of the assets of KTB AD, namely that the bank's controlling and management bodies have applied vicious banking and business practices, and for years have submitted untrue and misleading financial and supervisory reports. Therefore, the BNB will forward the report of the supervisory inspection conducted in the period 7.07.–14.10.2014 to the Sofia City Prosecutor's Office.

## IV. BNB'S WORK WITH THE MAJOR SHAREHOLDERS OF CORPORATE COMMERCIAL BANK AD

Bromak EOOD holds 50.66 per cent of KTB's capital.

*Bulgarian Acquisition Company II S.a.r.L.*, Luxembourg, holds 30.35 per cent of KTB's capital. The company is indirectly controlled through other companies of the State General Reserve Fund of the Sultanate of Oman.

*VTB* holds 9.06 per cent of KTB's capital.

In June 2014, when publications on the KTB issue started to appear more often in the media and on the Internet and during the deposit run on the bank that followed in the period 12.06 – 20.06.2014, which led to placing the bank under special supervision, the bank's shareholders did not ask for a meeting with the BNB management, nor did they offer any liquidity or other kind of support. During the deposit run on the bank, the sole owner of the majority shareholder Bromak EOOD, Tsvetan Vasilev, was abroad. Contact with him was through the bank's executive directors. On 20.06.2014, they deposited a request with the BNB for the bank to be placed under special supervision due to depleted liquidity and suspended payments.

The only BNB contact with the bank's major shareholders, right after the bank was placed under special supervision, was with the *Bulgarian Acquisition Company II S.a.r.L.* representative who is a member of the bank's Supervisory Board. On 22.06.2014, a meeting was held on the BNB's premises, which discussed the situation and the bank's critical financial health. At this meeting, the representative of the second largest KTB shareholder stated that until then he was not informed in advance, by either the KTB management or majority owner, of the developing liquidity crisis and the liquidity problems experienced by the bank in the preceding week that had led to its placement under special supervision.

On **24.06.2014**, *VTB* issued a press release stating that it did not plan to provide liquidity to KTB.

On **10.07.2014**, a letter from the State General Reserve Fund of the Sultanate of Oman to BNB Governor and the Minister of Finance was received. The letter proposed relaxing the KTB special supervision and opening the bank within 3-6 months; appointing a chairperson of the Supervisory Board, proposed by the BNB; BNB supporting KTB with deposits when needed, as well as BNB imposing a weekly limit on deposit withdrawals of up to 5 per cent per customer. The letter did not contain any proposal for providing a financial resource to realise the specified measures.

On **10.07.2014**, a meeting was held with representatives of the State General Reserve Fund of the Sultanate of Oman attended by BNB Governor Ivan Iskrov, Deputy Prime-Minister Daniela Bobeva and Finance Minister Petar Chobanov. The Fund's representatives were informed of the outcomes of KTB and CB Victoria EAD's asset review conducted by the three audit firms. The representatives of the State General Reserve Fund of the Sultanate of Oman reiterated the proposals made in their letter of 10.07.2014. In this relation, it was explained to them that these did not comply with the Bulgarian legislation.

On **22.07.2014**, the BNB sent a letter to the State General Reserve Fund of the Sultanate of Oman in response to their letter of 10.07.2014. The BNB letter informed of the outcomes of the partial review of KTB and CB Victoria EAD's assets indicating that a substantial part of the credit portfolio of BGN 3.5 billion could not be assessed due to insufficient information available at the bank, including missing documentation in the credit files. Information was given about the arranged extensive review of KTB assets and the deadline for its completion by the three audit firms. The letter specified that the BNB could not provide financial resource to KTB as the requirements of Art. 33 of the LBNB could not be met. It explained that in order for KTB to open, not only capital but also serious liquidity support would be needed.

On **22.08.2014**, the BNB sent letters to the bank's major shareholders – Bromak EOOD and the State General Reserve Fund of the Sultanate of Oman. The letters described in detail the current situation with the KTB noting that the bank continued to suffer a huge liquidity shortage for paying out its obligations to depositors and other creditors, which were around BGN 6.3 billion. The shareholders were invited to provide, within 7 days, information to BNB of their concrete intentions and plans of resuming the bank's normal operation and maintaining its viability in the future. It was emphasised that given the huge liquidity shortage, their plans would have to include the provision of capital, but above all of liquidity support, so that the expected considerable liquidity pressure on the bank, if it eventually opened, could be met.

On **29.08.2014**, a response was received from the State General Reserve Fund of the Sultanate of Oman to the BNB letter of 22.08.2014. It recalled that with its letter of 22.07.2014 the Fund had proposed a co-surveillance over KTB by the current shareholders and the BNB. The letter stated that a firm commitment for investment in KTB could be taken only after the parties have had enough time to get acquainted with the outcomes of the assessment carried out at KTB by the three audit firms. The BNB was notified that *EPIC* and lawyers were engaged as advisers in the process. Other new potential investors also manifested interest in providing capital if, however, the State would also provide adequate support.

On **29.08.2014**, a response to the BNB letter of 22.08.2014 was also received from Bromak EOOD, signed by its sole owner Tsvetan Vassilev. The letter stated that Mr. Vassilev was continuously in contact with his partners from the State General

Reserve Fund of the Sultanate of Oman, from *VTB* and with other investors. It stated that in the next days the investment company, which was to lead the project, would submit to the BNB and the Government a structured proposal.

On **10.09.2014**, a letter from *EPIC* was received at the BNB. It notified that a consortium of shareholders and potential investors had been set up to recapitalise the bank without giving any specific names, as well as that for the purpose of this operation *EPIC*'s balance sheet would be utilised without elaborating on how this would be achieved. It stated that the State aid would be a significant part of the solution for recapitalising the bank. Extensive financial information on the bank was requested.

On **12.09.2014**, the BNB received a letter from *EPIC* specifying that they represented Bromak EOOD, *VTB* and the Sate General Reserve Fund of the Sultanate of Oman.

On **15.09.2014**, the BNB answered *EPIC*'s letter stating that it was necessary that they provided documents certifying the scope of their delegated powers and the persons they were authorised to represent. More information was also demanded about how they saw KTB's recapitalisation, including by specifying the financial commitments which the persons, represented by *EPIC*, were in a position to take and the way and legal methods they believed could be employed to achieve this, including the utilisation of *EPIC*'s balance sheet in this operation as suggested by them. A recommendation was given that talks with the Ministry of Finance should be immediately commenced in view to clarify the actual possibilities and conditions whereby a State aid could be granted. The BNB noted that at that point the two banks continued to suffer huge liquidity shortage for repaying their obligations to depositors and other creditors. It was explained that the necessary financial information would be provided by KTB's conservators after presenting an agreement or another document certifying *EPIC*'s representative powers and after signing a non-disclosure agreement between *EPIC* and KTB, which would also define the scope of information to be provided by the bank.

On **30.09.2014**, the BNB sent a letter to *EPIC* stating that the shareholder *Bulgarian Acquisition Company II S.a.r.L.*, Luxembourg – a company indirectly controlled, but not identical with the State Reserve Fund of the Sultanate of Oman – had not presented a letter of mandate to the BNB. It was pointed out that the information, requested by BNB in a letter of 15.09.2014, was not yet provided. In acknowledgement of the seriousness of the investment intentions, it was noted that a certificate was expected to be presented issued by a recognised and reputed bank about the size and availability of the funds and/or other assets, which could be used to recover KTB in case such decision be taken after reviewing the necessary information. The letter further stated that a proposal for draft Non-disclosure agreement was expected which should be studied within a short time and, if necessary, supplemented by KTB and CB Victoria's conservators and their teams.

On **30.09.2014**, the BNB received via e-mail a draft Non-disclosure agreement. It was a standard one without specifying the required information and the terms of using it.

On **2.10.2014**, an e-mail was received from *EPIC* stating that it was very unusual asking for evidence of finds from someone representing a state fund and the second largest Russian bank.

On **3.10.2014**, in response to *EPIC*'s e-mail, the BNB sent a letter stating that *EPIC* had not submitted documents evidencing that it represented *VTB*. It also stated that until then, no documents had been submitted certifying that *EPIC* represented the shareholder *Bulgarian Acquisition Company II S.a.r.L.*, and those submitted by the State General Reserve Fund of the Sultanate of Oman were signed by a person without any clearly evidenced representative power. It was also noted that Bromak EOOD's participation as investor also needed evidence as far as its public financial statements indicated limited financial resources. Besides, in relation to the information in the media about investigations against Bromak EOOD's sole owner, considerations should be given that evidences would be needed whether it would still meet the reliability and eligibility requirements as a bank shareholder under the banking legislation. It was also explained that *EPIC* was not expected to give an evaluation of the required funds in the KTB case; however evidences had to be supplied of the readiness and ability of potential investors to ensure funds, in which case it would be reasonable and in line with standard practices of requesting confirmation from a third party (bank). A confirmation was requested whether the understanding, based on document so far submitted, that *EPIC* was only an authorised representative and consultant of Bromak EOOD and of the State General Reserve Fund of the Sultanate of Oman, but did not intend to personally engage in KTB recovery, was correct.

On **8.10.2014**, after the conservators of the two banks placed under special supervision reviewed the draft Non-disclosure agreement, the BNB sent their notes to *EPIC*. The notes stated that a list of the confidential information to be submitted in compliance with the Bulgarian legislation should be attached to the agreement, as well as of the persons who would have access to this information. It was explained that the information could be accessed only on the site – on the banks' premises.

On **16.10.2014**, the BNB sent a letter to *EPIC* saying that on 15 and 16.10.2014 information was spread in the Bulgarian media of their visit on 15.10.2014 to Sofia, during which meetings were held with KTB depositors and financial experts. After the meetings there were statements that *EPIC* represented the three major shareholders of KTB; had worked out several solutions for the bank's restructuring; wished to recapitalise KTB and was ready to contribute to the bank's capital either on a solo basis or in cooperation with the state BGN 600 million, but did not receive sufficient support or the needed understanding from the Bulgarian authorities, the BNB including, in order to assess the actual situation of the KTB.

The BNB stated in its letter that these assertions did not correspond with the truth, were misleading to the Bulgarian public and were aimed at undermining BNB's reputation. The manner of communication through the media and not directly with the competent state authorities was not helping KTB or the persons *EPIC* claimed to represent. It stated that in all its letters so far the BNB had insisted on receiving clear information supported by the relevant accompanying documents concerning the persons represented by *EPIC*, the concrete financial commitments they would be able to take and the actual availability of funds or other assets which the persons represented intended to use for KTB restructuring in case such a decision were to be taken, as well as through what scheme and person/persons that could be achieved. It was reminded that *EPIC* did not submit to BNB documents certifying that it represented the shareholder *VTB*, just as no response was received to the notes and proposals, sent on 8.10.2014, on the text of the draft Non-disclosure agreement, which was to be signed along with the conservators of KTB and Victoria EAD. It was indicated that without clarity about the persons they represented, their investment plans and the funds through which they could be realised, it would be impossible to hold and successfully complete the relevant discussions. A month after the start of the correspondence, the issues raised by the BNB remain unanswered and the larger part of the requested documents – unavailable. In case the indicated minimum information, needed to start a negotiation process, is provided, the BNB is ready to immediately provide the necessary support, including for access to the needed information about KTB and CB Victoria EAD.

On **19.10.2014**, the BNB received documents certifying that *EPIC* was authorised to represent *Bulgarian Acquisition Company II S.a.r.L.*

On **19.10.2014**, in an interview on Nova TV in the Dikoff programme, Mr. Tsvetan Vassilev claimed that the consortium had submitted an offer for the restructuring of Corporate Commercial Bank, but the BNB “was silent“.

On **20.10.2014**, the BNB notified with a press release that no such offer had been received.

On **20.10.2014**, the BNB received a letter from *EPIC* stating that they did not stand behind Tsvetan Vassilev's public statements. A meeting with the BNB was requested.

On **20.10.2014**, the BNB received a letter signed by managers of *EPIC*, the State General Reserve Fund of the Sultanate of Oman and Gemcorp. It stated that with regard to the concrete commitments and figures related to KTB, such could be expected only after an agreement was reached on the main parameters, including the issues of how much capital would be needed, what level of deposits would be required, and what aid the government could provide for deposits and limiting withdrawals only up to critical levels. The request for a meeting with the BNB after 20.10.2014 was reiterated.

On **20.10.2014**, the BNB sent a response to *EPIC*, the State General Reserve Fund of the Sultanate of Oman and Gemcorp. It stated that the BNB had always timely replied to the letters from the State General Reserve Fund of the Sultanate of Oman and to those from EPIC and had been consistent in its stand. In its letters the BNB had requested EPIC many times to submit clear information supported by the relevant authorisation documents concerning the represented persons, their financial commitments and the plan to carry them. The information received pointed in different directions. In the last letter of 20.10.2014, a consortium was specified comprising EPIC, which until then had been specified only as an authorised representative of KTB shareholders, the State General Reserve Fund of the Sultanate of Oman and a new company under the name of Gemcorp, of which no documents were presented. Neither did the letter state whether EPIC continued to represent Bromak EOOD. It also pointed out that so far no draft action plan had been presented to the BNB.

On **24.10.2014**, a meeting was held between BNB, EPIC, the State General Reserve Fund of the Sultanate of Oman and Gemcorp representatives. During the meeting, the BNB representatives were informed that a newly set up consortium of the specified three investors was having discussions with the government and the parliamentary represented political forces about working out a plan for KTB recapitalisation and restructuring, which would also include funds provided by a state aid. On the BNB side, it was mentioned that the plans for KTB's recapitalisation and restructuring had to be supported with clear evidence of the availability of funds to be invested, as well as the time frames and instruments, through which the investment intentions would be carried out, in view of the deadline of the special supervision – 20.11.2014. The BNB was asked for support in providing access to the audit firms' reports containing KTB asset analysis and assessment. To the extent the BNB is not a party to the contracts between KTB conservators and the audit firms, and the reports may not be disclosed without the auditors' permission, it was stated that support would be provided in establishing contact and access to the reports under conditions determined between the consortium and the auditors.

## V. BNB'S ACTIONS CONCERNING CONDUCTING A REVIEW OF THE SUPERVISORY FRAMEWORK AND PRACTICES

### 1. WORK WITH THE EUROPEAN BANKING AUTHORITY

On **4.07.2014**, the BNB started talks with the Chairman of the European Banking Authority (EBA), Mr. Andrea Enria, initiating a review of the quality, capacity, practices and procedures of BNB Banking Supervision Department.

On **25.07.2014**, the BNB Governor sent a letter to EBA Chairman summing up the facts related to the placement of KTB and its subsidiary under special supervision, providing information about the decisions taken by the BNB and reiterating the invitation to EBA to organise an independent review of the quality, capacity, practices and procedures of BNB Banking Supervision Department. In his letter, the BNB Governor expressed readiness to cooperate with the EBA and emphasised the Central Bank's willingness for the review to be conducted in a timescale suggested by EBA, but no later than the end of the year.

The EBA Chairman informed the BNB Governor on 10.10.2014 that given the BNB request to IMF to organise a mission under the Financial Sector Assessment Program (*FSAP*) and the commenced work at the BNB for self-assessment of compliance with the "Basel Core Principles" (*Basel Core Principles for Effective Banking Supervision of 14 Sept 2012*) as part of the first stage of *FSAP*, the EBA considered as most efficient working in cooperation with IMF and the World Bank. During this process of cooperation, the EBA would also decide whether it should carry out an additional review of the supervisory framework and the supervisory practices at the BNB.

### 2. WORK WITH THE INTERNATIONAL MONETARY FUND (IMF)

On **8.08.2014**, the BNB Governor sent a letter to the Head of the IMF's Monetary and Capital Markets Department requesting an IMF *FSAP* mission to Bulgaria. In his letter, the BNB Governor informed IMF of KTB's placement under special supervision and described the measures undertaken to resolve the situation and confine systemic risks to KTB. It was noted that the banking system remained sound and normally functioning; yet the IMF's timely mission would help restore confidence in the banking system and sustain the financial stability.

In response to the Central Bank's request, on **25.08.2014** IMF informed that given the large number of *FSAP* missions already planned, organising such mission to Bulgaria would be possible no earlier than mid-2015.

With a letter dated **1.10.2014**, the BNB and the Ministry of Finance received confirmation from the World Bank Vice-President for Europe and Central Asia Region and the Head of IMF's Monetary and Capital Markets Department that an *FSAP* mission to Bulgaria could be organised no earlier than mid-2015. A suggestion was made for conducting an assessment of compliance of supervisory practices in Bulgaria with the "Basel core principles" (*Basel Core Principles for Effective Banking Supervision of 14 Sept 2012*) for efficient banking supervision as a first stage of conducting *FSAP*. Currently, work on this self-assessment is already in progress in BNB Banking Supervision Department.

# VI. BNB'S ACTIONS TOWARDS PROVIDING ACCESS TO DEPOSITS WITH CORPORATE COMMERCIAL BANK AD

## 1. WORK WITH THE EUROPEAN COMMISSION

On **1.08.2014**, with a letter from the Permanent Representative of the Republic of Bulgaria to the European Union, a letter was forwarded from Mr. Jonathan Faull, Director General of Directorate General (DG) for 'Internal Market and Services' at the European Commission (EC). The letter expressed concerns about the situation with KTB given the lack of access to deposits with the bank for 30 days and the prospect of this situation to continue. It stated that according to Directive 94/19/EC, amended with Directive 2009/14/EC on deposit guarantee schemes (Directive), Member States must be able to pay compensation within 20 business days from the date the competent authorities have determined "unavailable deposit" in accordance with Art. 1, paragraph 3, item i<sup>7</sup> and Art. 10, paragraph 1<sup>8</sup> of the Directive.

On **11.08.2014**, the BNB Governor and the Minister of Finance sent a joint letter reflecting the position of the two institutions on the issues raised by the European Commission (EC). The European Commission was notified of the chronology of actions undertaken by the BNB with regard to KTB and CB Victoria EAD, including a draft law on restructuring the two banks, which however was not supported by the major political forces. The EC was notified of the assigned, on 25.06.2014, assessment of KTB and CB Victoria EAD's assets and of its outcomes, as well as

---

<sup>7</sup> 'Unavailable deposit' shall mean a deposit that is due and payable but has not been paid by a credit institution under the legal and contractual conditions applicable thereto, where either:

(i) the relevant competent authorities have determined that in their view the credit institution concerned appears to be unable for the time being, for reasons which are directly related to its financial circumstances, to repay the deposit and to have no current prospect of being able to do so.

The competent authorities shall make that determination as soon as possible and in any case no later than five business days after first becoming satisfied that a credit institution has failed to repay deposits which are due and payable; or

(ii) a judicial authority has made a ruling for reasons which are directly related to the credit institution's financial circumstances which has the effect of suspending depositors' ability to make claims against it, should that occur before the aforementioned determination has been made;

<sup>8</sup> "Deposit-guarantee schemes shall be in a position to pay duly verified claims by depositors in respect of unavailable deposits within 20 business days from the date on which the competent authorities make the determination described in Art. 1, paragraph 3, (i) or the judicial authority makes the ruling described in Art. 1, paragraph 3, (ii). This term includes collection and submittal of correct data about depositors and deposits needed for review of [the claim]."

of the assigned in July thorough assessment of KTB assets, and of the possible actions which the BNB might undertake depending on the outcomes of the assessment within its legal competences, namely, revoking the bank's license if its own funds is a negative value. Clarifications were provided of the relevant provisions implementing the Directive in the national legislation, of which the EC was duly and timely notified. EC was informed that Bulgaria had no legislation on bank restructuring or a fund established for the purpose. Relevant steps had been undertaken for timely transposition, by the end 2014, of the new Directive 2014/59/EC establishing a framework for the recovery and resolution of credit institutions and investment firms and the new Directive 2014/49/EU on deposit guarantee schemes in the national legislation. It was further stated that since the National Assembly was currently not functioning, it was not possible to either adopt amendments to the national legislation, if necessary, or provide the needed funds from the state budget to cover the shortfall for the insured deposits.

On **18.08.2014**, a notification was received from DG 'Internal Market and Services' at EC for a potential violation by the Republic of Bulgaria of Directive 94/19/EC and of the Treaty on the Functioning of the European Union (TFEU). It stated that the violation consisted of potential non-compliance of the Bulgarian legislation with Art. 1, paragraph 3, item (i) and Art. 10, paragraph 1 of the said Directive; there was an incorrect application of Art. 1, paragraph 3, item (i) of the Directive, as well as a violation of the free movement of capital under Art. 63 of the Treaty on the Functioning of the EU.

On **27.08.2014**, the BNB and the MoF sent an exhaustive joint response to the EC giving their position on all issues raised by the EC.

It stated that there were certain constraints related to the effective legal framework in Bulgaria that did not allow the Bank Deposit Guarantee Fund to pay out the insured deposits prior to revoking the bank's licence by the competent authority. The provisions of the Law on Credit Institutions entitle the BNB, at its own discretion, to suspend for a definite period of time all or part of the bank's obligations, including the access to deposits, during the term of the special supervision, which may continue up to six months. It indicated that the National Assembly was dissolved and pre-term parliamentary elections would be held on 5 October 2014; thus, if legislative amendments were needed, they could not be finalised before the new Parliament was constituted.

Enclosed to the letter was extensive information for the existence of relevant provisions in the Bulgarian legislation which correctly transposed the Directive.

Regarding the EC's request for direct application of Art. 1, paragraph 3, item (i) of the Directive, it was noted that this provision was not 'unconditional, sufficiently clear and precise' so as to qualify for direct application by the authorities of a Member State. It was noted that any judgement of the availability of the conditions set

forth under Art. 1, paragraph 3, item (i) of the Directive by the competent authority outside the procedure of establishing insolvency would be biased, unfounded and premature, and it would, therefore, go beyond the limits of the law applicable in this case. By revoking the license of the bank, however, as provided under the law, the conditions referred to in Art. 1(3), item (i) of the Directive should be deemed to have irreversibly and irrevocably occurred.

It was clarified that the Directive provided for minimum harmonisation, which enabled the Member States to decide how to determine whether a credit institution has failed to pay out deposits that are due and payable under Art. 1, paragraph 3, item (i). The choice of the relevant act by which the unavailability of the deposits is determined, was left to the Member States, depending on their legal system.

Additionally, it was noted that the direct application of Art. 1, paragraph 3 (i) of Directive 94/19/EC would also have had significant financial implications for the BDIF, which could hardly be based on specific interpretations without any explicit and clear legal provisions. It was noted that even if we assumed that as a result of direct application of Art. 1, paragraph 3 (i) of the Directive the deposits with KTB were unavailable, there were no legal grounds for the BDIF to start paying out deposits up to the amount of funds collected in it, because by law that was only possible when a bank's license had been revoked, while the members of the Fund's Management Board were responsible for their decisions under the Bulgarian law.

KTB's actual financial position can be established on the basis of the full assessment of the bank's assets, which will provide the grounds for the supervisory authority to make a decision that is legally and economically grounded. Based on the assessment of KTB's financial position it will also be determined whether the other condition of Art. 1, paragraph 3, item (i) of the Directive is met, namely that the bank has no current prospect of being able to pay out deposits.

Considering the arguments provided by Bulgaria, the EC in its later communication with the Bulgarian authorities suspended the claim on direct applicability of Art. 1, paragraph 3, item (i) of the Directive by the Bulgarian authorities.

On **26–28.08.2014** within the visit of an EC delegation to Sofia meetings were held with representative of the BNB, MoF and BDIF to discuss the issues relating to the potential violation of the Directive and how that could be corrected.

In the period **1–15.09.2014** within the created experts group of representatives of the EC, EBA, ECB, MoF, BNB and BDIF conference talks were held and additional views were exchange by e-mail about the possibilities of ensuring full or partial access to deposits.

As for the EC's proposal for ensuring partial access to deposits, it was noted that the national law provided for no rules or procedures entitling the BNB to make such a decision or defining its contents. The BDIF's obligation to repay the insured deposit amounts, provided there are grounds for such a repayment, should not be mixed with a repayment, that is partial and in minimum amount, of the

claims on certain types of deposits at the expense of the funds of a bank placed under special supervision which are extremely insufficient. There are no provisions according to which, in case of insufficient liquid funds in a bank, partial distribution of these funds can be made. Moreover, in case of partial repayment, some creditors' receivables would be 100 percent repaid, while others would receive less than 1 percent, which would not be compliant with the principle of proportional satisfaction of receivables, in case of insolvency proceedings. There is no clear criterion by which it can be ascertained which receivables and which classes of creditors would be subject to partial satisfaction, and which not. The Bulgarian legislature has not granted the BNB any powers to allow or deny partial access to a bank's deposits or to distribute its available liquid funds, and any such decision made by the BNB would be arbitrary and might lead to legal uncertainties.

On **29.09.2014** in a letter received through the Council of Ministers administration, the BNB was informed about Infringement Procedure No. 2014/2240 opened by the EC on 25.09.2014 for Bulgaria's failure to comply with Art. 1, paragraph 3, and Art. 10, paragraph 1 of Directive 94/19/EC, amended by Directive 2009/14/EC.

On **8.10.2014** the BNB sent a letter to the Minister of Finance and the Council of Ministers, explaining in detail its position in response to the above stated procedure, which was almost fully incorporated into the position of the Republic of Bulgaria.

On **15.10.2014** the Council of Ministers passed the following resolution on Protocol No. 42 of 15.10.2014, approving the position of the Republic of Bulgaria on EC's Infringement Procedure No. 2014/2240:

### **1. Regarding the alleged non-compliance of the Bulgarian law with Art. 1, paragraph 3 and Art. 10, paragraph 1 (1) of the Directive**

Directive 94/19/EC has been transposed into the national law in the Law on Bank Deposit Guarantee and the Law on Credit Institutions. The texts of the main provisions of the Bulgarian law, adopted in the field covered by the Directive, have been duly notified to the EC within the required time periods. It should be noted that when transposing the Directive into the national law, the Bulgarian legislator sought to give a legal form of the outcome intended by the European legal act, while considering the specific provisions and the spirit of the Directive and aiming at consistency and coherence of the entire legal framework. This is the meaning of Art. 288, paragraph 3 of the Treaty on the Functioning of the European Union (TFEU) too.

The understanding of the Bulgarian side is that for a deposit to be determined as 'unavailable' under Art. 1, paragraph 3 of the Directive, three conditions must be present cumulatively, namely: i) the deposit must be due and payable, but unpaid;

ii) the relevant competent authority must have determined that the credit institution concerned appears to be unable for the time being, for reasons directly related to its financial circumstances, to repay the deposit; and iii) it has no current prospect of being able to do so. When all three conditions exist, the Directive obliges the Member States to provide the insured depositors, within 20 business days as of the date when the competent authorities determined the presence of the above three pre-conditions, with access to their deposits in the amount as specified in the Directive.

In the light of the aforementioned, when these three conditions exist, the Bulgarian legislator assumes that the relevant institution is insolvent and for that reason it obliges with an imperative legal provision the competent authority – the Bulgarian National Bank – to withdraw the bank’s license (Art. 36, paragraph 2, item 1 of LCI). The conditions for withdrawing a license under Art. 36, paragraph 2 of LCI are directly related to a credit institution’s financial circumstances and its resultant inability to pay out the deposits to its clients in the near future. Within 20 business days as of the date of the license withdrawal by the BNB, the BDIF starts to pay out the insured deposit amounts to the depositors.

Bulgaria assumes that the relevant competent authority’s determining that a credit institution appears to be unable, for reasons directly related to its financial circumstances, to pay out deposits does not differ in economic sense from the procedure for determination of insolvency of that credit institution.

It should also be pointed out that the Directive sets out minimum harmonisation, and thereby the Member States can use discretion to decide how to determine whether a credit institution has not paid out deposits which are due and payable under Art. 1, paragraph 3, item (i).

The Directive allows the Member States to choose an act which is consistent with the specific national administrative and legal procedures. Neither the Directive, nor Directive 2014/49/EU specify what the word ‘determine’ implies, nor do they prescribe the act on, or the manner of, determination. The Directive leaves room for the Member States to decide by what act of the competent authority, consistent with the specifics of their national law, the determination under Art. 1, paragraph 3, item i) of the Directive will be made.

The assessment of a bank’s financial position, indicating that the bank is unable to pay its obligations due or that its equity is a negative value, is the prime economic and legal reason for the mandatory withdrawal of its license, which is subject to judicial review. On the opposite, the conclusion that a bank is unable to pay out its deposits, without clarity of its financial position, would be economically and legally unsubstantiated. Paying out unavailable deposits from the national deposit guarantee schemes, before a precise assessment of a bank’s financial position is available, would amount to losing a considerable number of the bank’s clients and its reputation, and could also impede the rehabilitation of the bank. Paying out deposits from the national deposit guarantee scheme, without the competent author-

ity having unconditionally determined the bank's insolvency, would lead to legal uncertainty and would imply unfounded spending of resources.

In case of established insolvency, the Bulgarian law stipulates that the credit institution's license is withdrawn within 5 days and the repayment of deposits is initiated within 20 days (Art. 36 of LCI and Art. 23 of LBDG). In case of liquidity shortage, however, which is not necessarily related to insolvency and withdrawal of a license, the early repayment of deposits from the BDIF, including through a state loan or state guarantee when the Fund's resources are insufficient, would impede any actions for the bank's recovery or restructuring. This would be the case if the deposit guarantee scheme is activated, for example, within 5 days as of placing the bank under special supervision, without a clear and final assessment of its financial position.

In the light of the aforementioned, Bulgaria assumes that before the procedure for establishing if a credit institution is insolvent is completed, it cannot be argued unconditionally that the bank is unable to repay its obligations, including the obligations to its depositors, and that for reasons directly related to its financial circumstances, there is no current prospect of being able to do so. Nevertheless, the Republic of Bulgaria agrees that there might be some inconsistency with the spirit of the Directive regarding the fast access of depositors to the protected amounts. Therefore, with future amendments to the national law, which are already being drafted, steps will be taken towards bringing it into full compliance with the new EU rules, including the special supervision measures. To date there is no effective legislation in Bulgaria for bank restructuring or any fund set up for that purpose. We are working on the implementation, by the end of 2014, of Directive 2014/59/EU Establishing a Framework for the Recovery and Resolution of Credit Institutions and Investment Firms and Directive 2014/49/EU on Deposit Guarantee Schemes.

## **2. Regarding the alleged breach of the TFEU provisions on free movement of capitals**

In response to the EC's findings about the breach of the free movement of capital, as provided for under Art. 63 and the following articles of the TFEU, Bulgaria is of the opinion that the exceptions allowed under Art. 65, paragraph 1 'b' of TFEU, related to prudent supervision of financial institutions, are present and temporarily applicable. These exceptions will apply until the end of the special supervision procedure due to risk of insolvency, which is envisaged as a temporary recovery measure by the laws of a Member State. This measure follows from the application of Directive 2001/24/EC of the European Parliament and of the Council on the Reorganisation and Winding Up of Credit Institutions, and the provided therein (Art. 2) possibility for suspension of payments when reorganisation measures are taken. Despite the above, considering the arguments of the EC, Bulgaria reiterates

that by the end of 2014 the special supervision procedure for banks, set forth under the LCI, will be substantially revised.

**In conclusion, the EC has been informed that a final decision about KTB and Commercial Bank Victoria EAD will be made in the period 1.11.2014 – 20.11.2014. Whatever the final decision, the depositors with insured deposits will in short time be given access to their funds with KTB and Commercial Bank Victoria EAD.**

## **2. WORK WITH THE EUROPEAN BANKING AUTHORITY**

On **31.07.2014** a letter was received from the Chairman of the EBA regarding a preliminary enquiry for potential breach of Union law. The BNB was informed that the EBA had taken preliminary actions to establish if there were any data to justify opening an investigation into a breach of Union law by the Bulgarian authorities.

On **19.08.2014** the BNB sent its response to the EBA, explaining the factual situation chronologically as from the date when KTB and Commercial Bank Victoria EAD were placed under special supervision, and describing the BNB Governing Council's decisions and measures taken to that moment. Furthermore, the BNB pointed out that Directive 94/19/EC had been transposed and the EC had been duly notified thereof within the required time periods, and the EC had not found out any discrepancies. The BNB also outlined the Bulgarian legal framework regulating the issues relating to depositors' access to their insured deposits. It was noted that there were no legal grounds for paying out the insured amounts of deposits with a bank under special supervision without a final assessment of the bank's financial position and without a conclusion on its insolvency made within the required procedure. In addition, the BNB clarified that there was no legal procedure for giving partial access to deposits.

On **22.09.2014** the BNB received a letter from the EBA's Chairman, notifying the BNB that a breach of Union law investigation had been opened under Art. 17 of Regulation (EU) No. 1093/2010 establishing the European Banking Authority. Substantiating its decision, the EBA expressed the position that the BNB should have applied Art. 1, paragraph 3 (i) of Directive 94/19/EU and as a competent authority it must have pronounced on the unavailability of deposits within the time period of 5 business days set forth by the Directive. In addition, the EBA pointed out that even if the BNB had not made that determination, the BDIF should have repaid the deposits because the suspended execution of KTB's obligations for the period of the special supervision was considered as determination of unavailable deposits.

On **29.09.2014** the BNB sent its position to the EBA regarding the opened procedure. The BNB stated that Directive 94/19/EC set out minimum harmonisation and required transposition measures which would achieve the intended result of the Directive, while giving due regard to the specifics of the national legal system. Therefore, the BNB emphasised that the measures enacted by the Bulgarian legislature provided for withdrawal of a bank's license as a pre-condition for the BDIF to repay deposits. The Central Bank underlined that special supervision was a supervisory measure, distinct from the BDIF's obligation to repay the insured deposits in case of established bank's insolvency and withdrawal of its license. The BNB informed the EBA that the assessment of KTB's financial position was not complete yet and that assessment would serve as a ground for the supervisory authority to make an economically and legally sound decision.

Furthermore, the BNB restated that there were no legal provisions on the basis of which, in case of a bank's insufficient liquid funds, partial repayment could be made and that there were no legal criteria for distribution of these funds in such cases. It was also noted that making such a decision without any legal grounds would pose a number of legal and economic risks, among which were indicated issues relating to the BDIF's rights in case of subrogation, infringement of creditors' rights in possible insolvency proceedings, *etc.* The BNB provided information about the timescale of the expected auditors' reports, the possible decisions that could be taken under the national law, and the time periods in which they could be made within the term of the special supervision on KTB, *i.e.* by 20.11.2014.

On 3.10.2014 the BNB and the BDIF received a letter from the EBA's Chairman regarding the preparation of a final investigation report and a proposal to the Board of Supervisors to adopt a Recommendation to the BNB and the BDIF with the enclosed EBA draft recommendation therewith.

On **7.10.2014** the BNB sent to the EBA its stance, stating that Art. 1, paragraph 3 (i) of the Directive, with regard to its minimum harmonisation, did not specify the manner of or the act on determination of 'unavailable deposits'. The BNB noted that it was left to the discretion of the national legislature, which in that particular case decided that the conditions for determining 'unavailable deposits' under the Directive were the same as those for establishing insolvency, respectively withdrawal of a license, under the national law. Therefore under the Bulgarian law, access to insured deposits may be granted by the BDIF within the time periods as set forth in the Directive, after the bank's license has been revoked. The BNB reminded that there were similar legal solutions in many other EU Member States. The BNB restated the absence of any legal grounds or procedure for giving partial access to deposits in case of insufficient liquid funds of a bank under special supervision.

On **14.10.2014** a meeting of the EBA Board of Supervisors discussed the draft recommendation and the BNB's views. The debate was long and heated, and the BNB's position was backed by a large number of the members of the Board of Supervisors. The recommendation was adopted by a slim majority.

On **17.10.2014** the EBA sent to the BNB and the BDIF the adopted Recommendation on actions necessary to comply with Directive 94/19/EC.

On **21.10.2014** the BNB replied to the letter of the EBA's Chairman of 17.10.2014.

In its response the BNB confirmed that the definition of 'unavailable deposit' under Art. 1, paragraph 3(i) of Directive 94/19/EC on deposit guarantee schemes, could not be directly applied insofar as it was not unconditional, sufficiently clear and precise, while those preconditions were identified by the CJEU as necessary to qualify for direct application. The definition itself grants no direct competences to a specific competent authority in a Member State; it merely states the characteristics of 'unavailable deposit'. In compliance with the definition, the national law should specify the relevant competent authority and set forth its competences, including specific national measures to determine whether deposits are 'unavailable'.

As the BNB has already pointed out, Directive 94/19/EC sets out minimum harmonization, and therefore transposition measures are required so as to achieve the result of the Directive, while also ensuring full compliance with the specifics of national legal framework and the legal system.

The determination of 'unavailable deposit' under Art. 1, paragraph 3(i) of Directive 94/19/EC is to be made by the 'relevant competent authorities' which, however, are designated under the national law and are vested with competences exhaustively listed in the national legislation.

In this respect, the only competence granted to the BNB under the relevant national legal provisions implementing Art. 1(3)(i) of Directive 94/19/EC, is to revoke a bank's license provided that the conditions laid down in Art. 36 of the Law on Credit Institutions are met. Revocation of a bank's license is subject to appeal before the Bulgarian Supreme Administrative Court. Any other decision made by the BNB outside its scope of competences would be null and void. Under the applicable national legislation the BNB is not competent to determine whether deposits in a credit institution are unavailable in any other manner but by revoking the banking license.

The above stated is also applicable to the Bulgarian Deposit Insurance Fund (BDIF), which is obliged to repay the guaranteed deposits under Art. 23 of the Law on Bank Deposit Guarantee only in cases where the BNB has revoked the license of the relevant bank. No other preconditions for repayment of deposits are envisaged under the effective legislation. Moreover, such a decision implies spending billions of levs from the BDIF's funds and cannot be approved without a clear and sound legal basis in the national law.

Any administrative authority can make its decisions and adopt administrative acts within the scope of its competences which are determined by the national law. Provided that the national law implementing the respective EU legislative act narrows its sense and fails to provide the designated competent authority with the full range of competences as required by that EU act, the national law should be amended.

The provisions of Art. 1(3)(i) of Directive 94/19/EC, which is in fact a definition, requires national implementation measures in compliance with the national legal order and particularities. Such measures, as stipulated under the Bulgarian legislation, provide for a revocation of the banking license as a precondition for any repayment of deposits from the BDIF. No other national measures are available in the legislation transposing the provision of Art. 1(3)(i) of Directive 94/19/EC.

Furthermore, placing a bank under special supervision, including suspension of execution of its obligations, is a national supervisory measure available under Section VIII of Chapter Eleven of LCI. This measure has been implemented by a respective administrative act which the BNB adopted in June 2014 in compliance with the conditions set forth under the law. The said act was not appealed before the court and entered into legal force. Under Art. 115, par. 3 of LCI, this measure can be imposed for a maximum term of six months. Provided that this term is excessively long compared to the term for repayment of guaranteed deposits under Directive 94/19/EC, the national law needs to be amended accordingly.

In light of the aforesaid, the BNB states that although the alleged non-compliance with the EU law is attributable to the BNB and the BDIF, neither of the two institutions is competent to revise the national law so as to ensure the correction of the non-compliance. Such competences are conferred only to the Bulgarian Parliament.

It is noted that there are no legal rules and procedures under the national law that enable the BNB to allow partial access to deposits. As specified above, except for the provision of Art. 23 of LBDG, no other preconditions for repayment of deposits are set forth under the Bulgarian law. What's more, there are no legal provisions on the basis of which, in case of substantially insufficient liquid assets, partial repayment or distribution of these liquid assets could be implemented. In such circumstances, the Bulgarian legislature has not granted the BNB any competence to allow or deny partial access to deposits. In this regard, any decision made by the BNB would be arbitrary and may lead to legal uncertainty.

Furthermore, the BNB has notified the EBA that the assessment and analysis of KTB's assets by the three audit firms – 'Deloitte Bulgaria' OOD, 'Ernst and Young Audit' OOD, and 'AFA' OOD – have completed. The BNB Governing Council has instructed the conservators to book the results from the analyses and assessment in full compliance with the International Financial Reporting Standards and by 31 October 2014 to provide the BNB with the necessary regulatory reports so that the decisions stipulated under the Law on Credit Institutions could be made.

Also, the BNB has informed the EBA about the measures that have already been undertaken. The BNB points out that Bulgaria has submitted a position, approved by the Council of Ministers, on the infringement procedure launched by the European Commission regarding the failure to comply with Directive 94/19/EC, about which Bulgaria was notified on 26 September 2014. With regard to the observation of the Commission for an incorrect transposition of Art. 1(3) and Art. 10(1)(1) of

Directive 94/19/EC, Bulgaria has stated that when transposing Directive 94/19/EC, the legislature aimed to achieve the result set by the European legislative act, giving due regard to the specific provisions, as well as to the spirit of the act as a whole. Nevertheless, the Bulgarian authorities have observed that there might be a non-compliance regarding the prompt access of depositors to their deposits. In order to deal with the said non-compliance, a new Law on bank deposit guarantee is being drafted. The respective time schedule for its enactment has been enclosed. A commitment has been made for transposing Directive 2014/59/EC on Establishing a Framework for Recovery and Resolution of Credit Institutions and Investment Firms by the end of 2014, which will introduce substantial changes in the special supervision procedure, envisaged under the Law on Credit Institutions. The new legislation being drafted will give due regard to the concerns expressed by the EBA and the EC.

The BNB expresses its readiness to continue providing its expertise on the matter and assist the competent authorities in Bulgaria in developing legislative changes so as to ensure full compliance with the Union law.

**Moreover, it should be noted that under Regulation (EU) No. 1093/2010 establishing the EBA, recommendations issued by the EBA are not obligatory and legally binding for the competent authorities. The Recommendation aims to ensure efficient, effective and consistent supervisory practices within the European System of Financial Supervision and the common, uniform and consistent application of Union law. The procedure prescribed in Articles 16 and 17 of Regulation (EU) No. 1093/2010 provides that when EBA's recommendations have not been complied with in the set time periods, the EBA will inform the EC, which in turn may issue a formal opinion.**